TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1935

No. 769

WILLARD M. EDWARDS, COLLECTOR OF INTERNAL REVENUE, PETITIONER

vs.

ARCHIBALD DOUGLAS, GEORGE NOTMAN, AND EDMUND COPPIN, AS EXECUTORS OF THE ESTATE OF JAMES DOUGLAS, DECEASED

ON [illegible] TO THE UNITED STATES [illegible] COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED [illegible]

CERTIORARI GRANTED [illegible]

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1924.

No. 524

WILLIAM H. EDWARDS, COLLECTOR OF INTERNAL REVENUE, PETITIONER

vs.

ARCHIBALD DOUGLAS, GEORGE NOTMAN, AND EDMUND COFFIN, AS EXECUTORS OF THE ESTATE OF JAMES DOUGLAS, DECEASED

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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1a

In United States District Court

Writ of error

UNITED STATES OF AMERICA, *ss:*

The President of the United States of America to the judges of the District Court of the United States for the Southern District of New York, greeting:

Because, in the record and proceedings, as also in the rendition of the judgment of a plea which is in the District Court, before you, or some of you, between Archibald Douglas, George Notman, and Edmund Coffin, as executors of the estate of James Douglas, deceased, plaintiffs, and William H. Edwards, collector of internal revenue, Second District, New York, defendant, a manifest error hath happened, to the great damage of the said Archibald Douglas, George Notman, and Edmund Coffin, as executors of the estate of James Douglas, deceased, plaintiffs, as is said and appears by their complaint, We, being willing that such error, if any hath been, should be duly corrected, and full and speedy justice done to the parties aforesaid, in this behalf, do command you, if judgment be therein given, that then under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the judges of the United States Circuit Court of Appeals for the Second Circuit, at the city of New York,

1b together with this writ, so that you have the same at the said place before the Judges aforesaid, on the 14th day of June, 1923, that the record and proceedings aforesaid being inspected, the said judges of the United States Circuit Court of Appeals for the Second Circuit may cause further to be done therein, to correct that error, what of right according to the law and custom of the United States ought to be done.

Witness, the honorable William H. Taft, Chief Justice of the United States, this 16th day of May, in the year of our Lord one thousand nine hundred and twenty three and of the Independence of the United States the one hundred and forty seventh.

[L. S.] ALEX. GILCHRIST, Jr.,
Clerk of the District Court of the United States of America, for the Southern District of New York, in the Second Circuit.

The foregoing writ is hereby allowed.

HENRY W. GODDARD,
U. S. District Judge.

1 In United States District Court for the Southern District of of New York

Summons

ARCHIBALD DOUGLAS, GEORGE NOTMAN AND EDMUND COFFIN, as executors of the estate of James Douglas, deceased, plaintiffs.

vs.

WILLIAM H. EDWARDS, COLLECTOR OF UNITED STATES internal revenue for the second district of the State of New York, defendant.

L 22 page 322.

To the above named defendant:

You are hereby summoned to answer the complaint in this action, and to serve a copy of your answer on the plaintiff's attorney within twenty days after the service of this summons, exclusive of the day of service; and in case of your failure to appear or answer,
2 judgment will be taken against you by default for the relief demanded in the complaint.

Witness, the Hon. Learned Hand, judge of the District Court of the United States for the Southern District of New York, at the city of New York this 9th day of August, 1920.

ALEX. GILCHRIST, Jr., *Clerk.*

DOUGLAS, ARMITAGE & MCCANN,
Plaintiffs Attorneys.

Office and post office address, 233 Broadway, Borough of Manhattan, New York City.

3 In United States District Court

[Title omitted.]

Complaint

The plaintiffs, by their attorneys, Douglas, Armitage & McCann, complaining of the defendant, respectfully show to this court and allege:

First. That at all times hereinafter mentioned, plaintiffs, Archibald Douglas, George Notman and Edmund Coffin, were and now are citizens of the United States and residents of the State of New York, and of the fourteenth, first, and second United States internal revenue districts of the State of New York.

Second. That James Douglas died on the 25th day of June, 1918, at Spuyten Duyvil, New York, and thereafter and on or about the 22nd day of August, 1918, his last will and testament,
4 together with three codicils were duly proved and duly admitted to probate in the Surrogates' Court of the county of Bronx of the State of New York; and pursuant to the provisions of said will and on or about the 22nd day of August, 1918, said Archibald Douglas, George Notman and Edmund Coffin, the plain-

tiffs herein, were duly appointed by said court and duly qualified as such and still are the executors of the estate of James Douglas.

Third. That on information and belief the said above named defendant is a citizen of the United States and a resident of the Borough of Manhattan, city, county and State of New York, and at all times hereinafter mentioned and still is the collector of the United States internal revenue for the second district of New York.

Fourth. That prior to the 1st day of March, 1913, said James Douglas was the owner and holder of 41,025 shares of the capital stock of Phelps Dodge & Company; that on or about the 2nd day of July, 1913, he purchased 25 shares of the capital stock of said Phelps Dodge & Company for the sum of $2,500 and thereafter and on or about the 1st day of April, 1917, said James Douglas, pursuant to a merger or consolidation hereinafter referred to, duly exchanged his said 41,050 shares of the capital stock of Phelps Dodge & Company for 41,050 shares of the capital stock of Phelps Dodge Corporation; that at the time of the death of the said James Douglas, on the 25th day of June, 1918, he was the owner and holder of the said 41,050 shares of the capital stock of the said Phelps Dodge Corporation, so received in exchange.

5 Fifth. That Phelps Dodge & Company was at all times hereinafter mentioned and prior to the 1st day of April, 1917, a corporation organized and existing under the laws of the State of New York, with a principal place of business at 99 John Street, in the Borough of Manhattan, city and State of New York.

Sixth. That prior to the 1st day of April, 1917, Copper Queen Consolidated Mining Company was a corporation organized on the 10th day of August, 1895, and existing under the laws of the State of New York, with an authorized capital stock of $2,000,000, all of which was issued and outstanding on the 1st day of April, 1917.

Seventh. That prior to the 1st day of April, 1917, Detroit Copper Mining Company of Arizona was a corporation organized on the 24th day of September, 1872, and existing under the laws of the State of Michigan, having an authorized capital stock of $1,000,000, all of which was issued and outstanding on the 1st day of April, 1917.

Eighth. That prior to the 1st day of April, 1917, Burro Mountain Copper Company was a corporation organized on the 20th day of January, 1914, and existing under the laws of the State of New Mexico, with an authorized capital stock of $8,000,000, all of which was issued and outstanding on the 1st day of April, 1917.

Ninth. That prior to the 1st day of April, 1917, Stag Canon Fuel Company was a corporation organized on the 8th day of De-
6 cember, 1905, and existing under the laws of the State of New Mexico, with an authorized capital stock of $500,000, all of which was issued and outstanding on the 1st day of April, 1917.

Tenth. That prior to the 1st day of April, 1917, Bunker Hill Mines Company was a corporation organized on the 3rd day of November, 1909, and existing under the laws of the State of West

Virgina, with an authorized capital stock of $1,000,000, of which $750,000 was issued and outstanding on the 1st day of April, 1917.

Eleventh. That prior to the 1st day of April, 1917, Phelps Dodge Mercantile Company was a corporation organized on the 12th day of December, 1911, and existing under the laws of the State of New York, with an authorized capital stock of $4,000,000, of which $2,000,000 was issued and outstanding on the 1st day of April, 1917.

Twelfth. That prior to and on the 1st day of March, 1913, the said Phelps Dodge & Company was the owner and holder of all the capital stock of the Copper Queen Consolidated Mining Company, the Detroit Copper Mining Company of Arizona, Burro Mountain Copper Company, Stag Canon Fuel Company, Moctezuma Copper Company, Bunker Hill Mines Company, and Phelps Dodge Mercantile Company.

Thirteenth. That on or about the 1st day of April, 1917, the directors and stockholders of Phelps Dodge & Company, Detroit Copper Mining Company of Arizona, Burro Mountain Copper Company, Stag Canon Fuel Company, Moctezuma Copper Company, Bunker Hill Mines Company, and Phelps Dodge Mercantile Company decided to consolidate into one company, in pursuance of which plan the capital stock of Copper Queen Consolidated Mining Company was duly increased to the sum of $50,000,000, divided into 500,000 shares with a par value of $100 each, its name was changed to the Phelps Dodge Corporation, and the assets thereof were transferred to and taken over by the said Phelps Dodge Corporation (Copper Queen Consolidated Mining Company) and all the companies thereupon were dissolved.

Fourteenth. That on the 1st day of March, 1913, the said shares of stock of Phelps Dodge & Company, so held as aforesaid by the said James Douglas, were of the value of $8,717,807.50, and at all times thereafter and until his death said stock has been of not less than said value.

Fifteenth. That for a long time prior to the 1st day of March, 1913, the said Phelps Dodge & Company was the owner and holder, and operator in its own name and through its holdings in the several corporations above mentioned, of various valuable copper mines containing copper ore, and that the value of the said copper mines was on the 1st day of March, 1913, at least the sum of $132,285,000.00.

Sixteenth. That subsequent to the 1st day of March, 1913, and prior to the 28th day of December, 1917, the said Phelps Dodge & Company and said several companies mined and extracted copper ore from the mines and the ore bodies that were known to exist in said mines on February 28, 1913, and sold said copper and copper ore so produced and out of the proceeds thereof set aside yearly fixed sums which represented the value of the said ore in the ground on the 1st day of March, 1913, which sums were for a depletion reserve to return the said capital value of the said ore to said corporation and their stockholders, and said reserves so created by the said corporations were maintained intact and held by

said corporations up to the 28th day of December, 1917, except as hereinafter stated.

Seventeenth. That at a meeting of the board of directors of the said Phelps Dodge Corporation, held on the 13th day of September, 1917, and after said consolidation as aforesaid, the said directors, acting under their duly constituted authority, declared out of the said reserve funds so created for depletion and which represented the proceeds of the sale of the capital assets of said several companies as represented by said ore bodies existing on March 1, 1913, a depletion dividend, which dividend was designated and described as "a distribution from the reserve fund for depletion" as follows:

"Whereas this company in accordance with the income tax section of the tariff act of 1913, and with the income tax law of September 8, 1916, has yearly, in computing its income, deducted therefrom a reasonable allowance for depletion of its mines, based upon the fair market volume thereof as of March 1, 1913; and

"Whereas the income tax law and the rulings of the Department of Internal Revenue provide for a separation of said deduc-
9 tions from income and provide further that payments to stockholders from said depletion account will be a return of capital invested, and are not subject to income tax in the hands of the shareholders:

"Therefore, resolved that this company distribute among its stockholders from said depletion account, three dollars a share, to be paid on September 28, 1917, to stockholders of record on September 24, 1917, the total amount so paid to be deducted from said depletion account."

Eighteenth. That thereafter the said Phelps Dodge Corporation duly paid and distributed out of said depletion funds or reserves so created by said several companies the said depletion dividend to its stockholders, and the said James Douglas, as such stockholder of said corporation, and the owner and holder of the shares of stock as aforesaid, duly received, on the 28th day of September, 1917, the sum of one hundred twenty-three thousand one hundred and fifty ($123,150) dollars as his proportionate share in such depletion dividend.

Nineteenth. That at a meeting of the board of directors of said Phelps Dodge Corporation held on the 13th day of December, 1917, and after said consolidation as aforesaid, the said directors, acting under their duly constituted authority, declared out of the said reserve funds so created for depletion and which represented the proceeds of the sale of the captial assets of said several companies as represented by said ore bodies existing on March 1, 1923, a depletion dividend, which dividend was designated and de-
10 scribed as "a distribution from the reserve fund for depletion" as follows:

"Whereas this company, in accordance with the income tax section of the tariff act of 1913, and with the income tax law of September 8, 1916, has yearly, in computing its income, deducted

therefrom a reasonable allowance for depletion of its mines, based upon the fair market value thereof as of March 1, 1913; and

"Whereas the income tax law and the rulings of the Department of Internal Revenue provide for a separation of said deductions from income and provide further that payments to stockholders from said depletion account will be a return of capital invested and are not subject to income tax in the hands of the shareholders:

"Therefore, resolved that this company distribute among its stockholders from said depletion account, five dollars per share, to be paid on December 28, 1917, to stockholders of record on December 18, 1917, the total amount so paid to be deducted from said depletion account."

Twentieth. That thereafter the said Phelps Dodge Corporation duly paid and distributed out of said depletion funds or reserves so created by said several companies the said depletion dividend to its stockholders and the said James Douglas, as a stockholder of the said corporation and as the owner and holder of the shares of stock as aforesaid, duly received on the 28th day of December, 1917, the sum of two hundred five thousand two hundred fifty ($205,250)
11 dollars as the proportionate share in such depletion distribution.

Twenty-first. That the said dividends were so declared and paid out of the said depletion reserve funds as a distribution of capital assets to the stockholders and as a proper reduction of the value of their capital stock in the said corporation and return to them according to their interest in the assets of the corporation on the 1st day of March, 1913. That the said dividends were declared as a dividend from the reserve fund for depletion and not in any sense as a distribution of income or profit and that they were not paid out of the profits or earnings accrued since the 1st day of March, 1913, but were paid entirely out of reserve fund so created, which represented the sale of capital assets and the amount received therefor, equal to the value of these capital assets on the 1st day of March, 1913, and not out of any excess or increase in value or profits made since March 1, 1913.

Twenty-second. That on or about the 28th day of March, 1918, James Douglas duly made and filed with this defendant, the said collector of the United States internal revenue for the second district of New York, his return of income received during the year ending December 31, 1917, and to his said return he attached a statement as follows.

"NOTE.—In addition to the monies received during the year 1917 as reported in the foregoing individual income tax return for 1917, I have received the following amounts:

12

1917		
Sept. 28.	Rec'd as a stockholder from the Phelps Dodge Corporation, 99 John Street, New York, N. Y., a distribution from reserve from depletion	$123,150
Dec 28.	Do	205,250
	Total	328,400"

Twenty-third. That the levy and collection on the part of the Treasury Department the defendant of the income tax on the sum of $329,700 is an attempt to levy a direct tax upon the capital or property of the late James Douglas, but without apportionment among the States in proportion to the population, as required by subdivision 4, secton 9, of article 1 of the Constitution of the United States. That said levying of a tax on the said $329,700 is an attempt to tax as income what was in fact capital or property of the late James Douglas and not income within the provisions of article 16 of the Constitution of the United States.

Twenty-fourth. That the said title 1 of the act of September 8, 1916, as amended by the law of October 3, 1917, and in particular section 31 thereof, as so construed and applied by the Treasury Department in respect to the levying of the said tax on said $329,700 is an attempt to levy a tax upon income which had accrued or been earned before March 1, 1913, and contrary to the sixteenth amendment of the Constitution of the United States.

13 Twenty-fifth. That the said title 1 of the act of September 8, 1916, as amended by the law of October 3, 1917, and in particular section 31 thereof, as so construed and applied by the Treasury Department in respect to the levying of the said tax on said $329,700 is an attempt to levy and collect a tax upon the capital or property of the late James Douglas owned by him before March 1, 1913, and therefore contrary to the provisions of the Constitution of the United States.

Twenty-sixth. That the said titles of said acts of Cangress make, in respect of tax, arbitrary and unreasonable discrimination, exceptions, exemptions, and classifications, in violation of fundamental requirements of the Constitution of the United States, and the requirement therein that taxes shall be uniform throughout the United States.

Twenty-seventh. In sundry other particulars, both in form and substance, the said acts of Congress purporting to impose said tax, and the rules and regulations promulgated in connection therewith by the Commissioner of Internal Revenue or the Secretary of the Treasury, and the demand and requirement to make said return and pay said sum, are all and each of them illegal and unconstitutional.

Twenty-eighth. That at all times herein mentioned the said Phelps Dodge Corporation was and is a going concern and there has been no dissolution, distribution, or liquidation of its capital assets, except as herein set forth.

Twenty-ninth. That prior to the 28th day of December,
14 1917, there had been no distribution of the capital assets of any of the said corporation to the said James Douglas, nor to any other stockholders, nor has there been any other distribution of the capital assets, except the two distributions hereinbefore set forth.

Thirtieth. That thereafter the above-named defendant, as collector as aforesaid, upon an audit of the return of income for the year

1917 of the said James Douglas, advised plaintiffs as executors of said James Douglas, deceased, by a notice in writing dated the 20th day of February, 1919, a copy of which is hereto annexed and marked "Exhibit I," that the amount of $329,805 was income for the year 1917, and included in said income were the two depletion dividends so paid by the said corporation as aforesaid, and taxable as such, and assessed a tax against the said James Douglas amounting to $173,579.72 based on additional alleged income, and further notified said James Douglas that failure to pay the said sum would cause a 5% penalty to accrue, together with interest at 1% per month from the date due until paid.

Thirty-first. That thereafter and on or about the 16th day of May, 1919, the above-named plaintiffs, as executors as aforesaid, duly paid said tax of $173,579.72 to the said defendants under protest and in order to avoid the penalties threatened by him and imposed by law for nonpayment, which said protest was in writing and filed with the defendant at the time of the payment of the said tax, copy of which protest is hereto attached and marked "Exhibit 2."

Thirty-second. That thereafter and on or about the 24th
15 day of November, 1919, the above-named plaintiffs, as executors as aforesaid, duly made and filed with the Commissioner of Internal Revenue a written claim for refund of taxes on Form 46, wherein and whereby they demand that the said amount of $173,579.72 be refunded and paid back to the said plaintiffs as a tax illegally and improperly assessed and collected.

Thirty-third. That thereafter and on or about the 19th day of April, 1920, said appeal to the Commissioner of Internal Revenue and claim for refund of the said tax was duly rejected in writing, copy of which rejection is hereto attached and marked "Exhibit 3."

Thirty-fourth. That no part of said illegal tax of $173,579.72 has been refunded or repaid, although the same has been duly demanded.

Thirty-fifth. That this is a suit of civil nature at common law and arises under the Constitution and laws of the United States and under the laws of the United States provided for internal revenue.

Wherefore, plaintiffs demand judgment against the above-named defendant in the sum of $173,579.72 together with interest on same from the 16th day of May, 1919, and costs and disbursements of this action.

DOUGLAS, ARMITAGE & MCCANN,
Attorneys for Plaintiffs.

Office and post office address, 233 Broadway, Borough of Manhattan, New York City.

16 [Jurat showing the foregoing was duly sworn to by Edmund Coffin. Omitted in printing.]

17 EXHIBIT "1" (ATTACHED TO COMPLAINT)

IT:RAA:P
30

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, February 20, 1919.

DOUGLAS, ARMITAGE & MCCANN.
Woolworth Building, 233 Broadway,
New York, N. Y.

SIRS: An investigation of the income tax liability of the late James Douglas, 99 John Street, New York City, N. Y., for the years 1915 to 1917, inclusive, based on a revenue agent's report and an audit in this office, indicates that there are further taxes due of $85.19 for the year 1915, $1,059.01 for 1916 and $173,579.72 for 1917.

The amended returns should read as follows:

1915

Gross income		$1,201,836.98
General deductions		81,268.20
Net income		1,120,568.78
Dividends	$1,071,257.37	
At source	89,176.42	
Exemption	4,000.00	
Total		1,164,433.79
18 Normal tax	None.	
Additional tax	57,284.12	
Tax previously paid	57,198.93	
Additional tax due	85.19	

1916

Gross income		$1,899,675.99
General deductions		110,268.81
Net income		1,789,407.18
Dividends	$1,757,561.97	
Exemption	4,000.00	
Total		1,761,561.97
Income subject to normal tax		27,845.21
Normal tax	$556.90	
Super tax	172,728.86	
Total tax due	173,285.76	
Tax paid	172,226.66	
Additional tax paid	1,059.10	

1917

Dividends 1913–1915	$915.00	
Dividends 1916	319,860.78	
19 Gross income		$1,566,114.09
Deductions		31,883.00
Net income		1,534,231.09
Less excess profits tax		2,520.00
Total		1,531,711.09
Less contributions		277,873.03
		1,253,838.06
Less 1917 dividends		1,427,987.65
Normal tax	None.	
Super tax	$590,141.22	
Tax on 1915 div	54.90	
Tax on 1916 div	35,921.67	
Excess profits tax	2,520.00	
Total	628,637.79	
Tax paid	455,058.07	
Additional tax due	173,579.72	

Assessment of the above amounts will be made on the next list sent the collector of your district.

Respectfully,

(Signed) HOMER S. PACE,
Acting Deputy Commissioner.

20 EXHIBIT "2" (ATTACHED TO COMPLAINT)

MAY 16, 1919.

COLLECTOR OF INTERNAL REVENUE.
For the Second District, New York.

James Douglas income tax—1917

DEAR SIR: We, George Notman, Edmund Coffin, and Archibald Douglas, executors of the estate of James Douglas, deceased, late of New York County, in the State of New York, herewith under duress and with protest and to avoid threatened penalty, which would in case of nonpayment on or before May 16th, 1919, be imposed in pursuance of notice received from you, a copy of said notice being hereto annexed, do make payment to you of the sum of $173,579.72 heretofore and now represented by you to be lawfully required and demanded of us and to be due to the United States under and in accordance with title 1 of an act of Congress of September 8, 1916, as amended October 3, 1917, as a tax upon and in respect to the net income of said James Douglas, deceased, and to have been lawfully assessed against him as such a tax for the year 1917.

But we hereby protest against being required to pay said sum and each and every part thereof, and we represent and declare that such payment is made under duress and only to avoid penalties and for-

feitures, the enforcement of which has been and is now threatened by representatives of the United States and by you and by
21 said act of Congress and by other acts which you have represented and do now represent as supporting your said demand.

We hereby particularly set forth and declare that the demand for said payment and the enforcement thereof are both unlawful and deprive us of rights secured to us by the Constitution and laws of the United States for the reasons hereinafter stated among others, but not excluding any other reasons which might now be given:

No lawful assessment of the said sum against us has ever been made, and said sum is not now due or owing to the United States by us either individually or as executors of the last will and testament of James Douglas, deceased, as a tax lawfully provided for by said act or acts.

That Douglas, Armitage & McCann, attorneys for the estate of James Douglas, received from the Treasury Department at Washington, under date of April 22, 1919, a communication signed J. H. Callan, assistant to the Commissioner, the last paragraph of which reads as follows:

"The increase of gross income in 1917 by over $329,000 is the result of including as 1917 income the amount as a depletion dividend, and not returned, examination of the accounts of the Phelps Dodge Co. paying this dividend, showing a surplus and undivided profits available for such dividend greatly in excess of this amount and which under the law will be deemed to have been paid from such reserve."

The undersigned state that the amount of $328,400, paid by Phelps Dodge Corporation to the late James Douglas in the
22 year 1917 was not a distribution from the surplus or undivided profits of Phelps Dodge Corporation, but was a payment out of the reserve for depletion set aside by said corporation in accordance with the income tax law applicable to corporations and that it was a distribution to the stockkholders and to said James Douglas of capital and not income.

The undersigned state that the amount of $1,000 paid by Calumet & Arizona Mining Company to the late James Douglas in the year 1917 was not a distribution from surplus or undivided profit of Calumet & Arizona Mining Company, but was a payment out of the reserve for depletion set aside by said corporation in accordance with the sections of the income tax law applicable to corporations, and that it was a distribution to the stockholders and to said James Douglas of capital and not income.

The undersigned state that the amount of $500 paid by Shatuck-Arizona Copper Company to the late James Douglas in the year 1917 was not a distribution from the surplus or undivided profits of the Shatuck-Arizona Copper Company, but was a payment out of the reserve for depletion set aside by said corporation in accordance with the sections of the income tax law applicable to corporations, and that it was a distribution to the stockholders and to said James Douglas of capital and not income.

That the levy on the part of the Treasury Department of an income tax on the sum of $329,700 is an attempt to levey a direct tax upon the capital or property of the late James Douglas, but without apportionment among the States in proportion to the population, as required by subdivision 4, section 9, of article 1 of
23 the Constitution of the United States.

That said levying of a tax on the said $329,700 is an attempt to tax as income what was in fact capital or property of the late James Douglas and not income within the provisions of Article XVI of the Constitution of the United States.

That the said title 1 of the act of September 8, 1916, as amended by the law of October 3, 1917, and in particular sec. 31 thereof, as so construed and applied by the Treasury Department in respect to the levying of the said tax on said $329,700, is an attempt to levy a tax upon income which had accrued or been earned before March 1, 1913, and contrary to the sixteenth amendment of the Constitution of the United States.

That the said title 1 of the act of September 8, 1916, as amended by the law of October 3, 1917, and in particular sec. 31 thereof as so construed and applied by the Treasury Department in respect to the levying of the said tax on said $329,700, is an attempt to levy a tax upon the capital or property of the late James Douglas, owned by him before March 1st, 1913, and therefore contrary to the provisions of the Constitution of the United States.

That the said titles of said acts of Congress make, in respect of said tax, arbitrary and unreasonable discriminations, exceptions, exemptions, and classifications, in violation of fundamental requirements of the Constitution of the United States and the requirements therein that taxes shall be uniform throughout the United States.

24 In sundry other particulars, both in form and substance, and said act of Congress purporting to impose said tax, and the rules and regulations promulgated in connection therewith by the Commissioner of Internal Revenue of the Secretary of the Treasury and the demand and requirement to make said return and pay said sum, are all and each of them illegal and unconstitutional, and notice is hereby given that in such time and in such manner as may be advisable, appropriate proceedings, including any action in law or in equity that may be deemed constitutional, will be taken against you and by any and all parties in interest in said sum and to preserve and protect all our rights and interest thereunto appertaining.

Wherefore we have signed this protest on the 16th day of May, 1919.

GEORGE NOTMAN,
EDMUND COFFIN,
ARCHIBALD DOUGLAS,
Executors of the estate of James Douglas, deceased.
By GEORGE NOTMAN.

25 EXHIBIT "3" (ATTACHED TO COMPLAINT)

IT:CL—BKH

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, April 19, 1920.

ARCHIBALD DOUGLAS ET AL.,
Executors of the Estate of James Douglas, deceased,
99 John Street, New York, N. Y.

SIRS: The claim filed by you as executors of the estate of James Douglas, deceased, for the refunding of $173,579.72 a portion of the individual income tax paid for the year 1917, has been examined.

You contend that dividends received during the taxable year from Phelps Dodge Corporation, the Calumet & Arizona Mining Company, and the Schatuck-Arizona Copper Company, declared out of a reserve for depletion of mining property did not represent taxable income to the recipient, but, on the contrary, represented a return of capital.

Section 31 of the revenue act of 1916, amended by section 1211 of the act of October 3, 1917, provided:

"(a) That the term 'dividends' as used in this title shall
26 be held to mean any distribution made or ordered to be made by a corporation, * * * out of the earnings or profits accrued since March 1, 1913, and payable to shareholders. * * *

"(b) Any distribution made to the shareholders or members of a corporation, * * * in the year 1917, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus and shall constitute a part of the annual income of the distribution for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, * * *. This subdivision shall not apply to any distribution made prior to August 6, 1917, out of earnings or profits accrued prior to March 1, 1913."

From the information secured by this bureau from the records of the corporation making the payments of dividends involved in your claim it appears that their surplus and undivided profits were sufficient to cover all distributions made during the year 1917. For this reason it is held that the payments received by Mr. Douglas were not a return of capital, but represented a distribution of earnings upon the capital stock which he held.

Your claim is accordingly hereby rejected.

Respectfully,

(Signed) WM. M. WILLIAMS,
Commissioner.

27 In United States District Court

[Title omitted.]

Answer

Defendant above named by Francis G. Gaffey, United State attorney for the Southern District of New York, his attorney answering the complaint herein, alleges:

I. Defendant denies that he has any knowledge or information thereof sufficient to form a belief as to each and every allegation contained in paragraphs numbered "first," "second," "fifth," "sixth," "seventh," "eighth," "ninth," "tenth," "eleventh," "twelfth," "thirteenth," "fourteenth," "fifteenth," "sixteenth," "twenty-eighth," and "twenty-ninth" of the complaint.

II. Upon information and belief defendant denies each and every allegation contained in paragraphs numbered "twenty-first,"
28 "twenty-third," "twenty-fourth," "twenty-fifth," "twenty-sixth," and "twenty-seventh" of the complaint.

III. Answering the allegations of paragraph numbered "fourth" of the complaint, defendant admits that during the year 1917 said James Douglas was a stockholder in Phelps Dodge Corporation except as herein above specifically admitted, defendant denies that he has any knowledge or information thereof sufficient to form a belief as to each and every allegation in said paragraph numbered "fourth" contained.

IV. Answering the allegations of paragraph numbered "seventeenth" of the complaint, upon information and belief, defendant denies that on the 13th day of September, 1917, the directors of Phelps Dodge Corporation declared a depletion dividend out of the reserve funds created for depletion and which represented the proceeds of the sale of the capital assets of the several companies as represented by the ore bodies existing on March 1, 1913; except as hereinabove specifically denied, defendant denies that he has any knowledge or information thereof sufficient to form a belief as to each and every allegation in said paragraph numbered "seventeenth" contained.

V. Answering the allegations of paragraph numbered "eighteenth" of the complaint, defendant admits that on or about the 28th day of September, 1917, said Phelps Dodge Corporation paid, and said James Douglas received, a dividend in the sum of one hundred twenty-three thousand one hundred and fifty dollars
29 ($123,150); upon information and belief defendant denies that said dividend was a depletion dividend, or that the same was paid or distributed out of the depletion funds or reserves created by the several companies; except as herein above specifically admitted or denied, defendant denies that he has any knowledge or

information thereof sufficient to form a belief as to each and every allegation in said paragraph numbered "eighteenth" contained.

VI. Answering the allegations of paragraph numbered "nineteenth" of the complaint, upon information and belief defendant denies that on the 13th day of December, 1917, the directors of Phelps Dodge Corporation declared a depletion dividend out of the reserve funds created for depletion, and which represented the proceeds of the sale of the capital assets of the several companies as represented by the ore bodies existing on March 1, 1913; except as hereinabove specifically denied, defendant denies that he has any knowledge or information thereof sufficient to form a belief as to each and every allegation in said paragraph numbered "nineteenth" contained.

VII. Answering the allegations of paragraph numbered "twentieth" of the complaint, defendant admits that on the 28th day of December, 1917, said Phelps Dodge Corporation paid, and said James Douglas received a dividend in the sum of two hundred five thousand two hundred and fifty dollars ($205,250); upon information and belief defendant denies that said dividend was a depletion dividend or that the same was paid or distributed out of the
30 depletion funds or reserves created by the several companies; except as herein above specifically admitted or denied, defendant denies that he has any knowledge or information thereof sufficient to form a belief as to each and every allegation in said paragraph numbered "twentieth" contained.

VIII. Answering the allegations of paragraph numbered "thirtieth" of the complaint, defendant admits that plaintiffs were duly advised that the amount of $329,805 was income for the year 1917 by a notice in writing dated the 20th day of February, 1919, in substantially the form of Exhibit 1 annexed to the complaint, but upon information and belief defendant denies that plaintiffs were so advised by defendant as collector of internal revenue or in any other capacity.

IX. Answering the allegations of paragraph numbered "thirty-first" of the complaint defendant admits that payment of said tax of $173,579.72 was made to defendant under protest, which protest was in writing and filed with defendant in substantially the form of Exhibit 2 annexed to the complaint, but for greater certainty defendant begs leave to produce upon the trial the original or a certified copy of said protest; defendant denies that he has any knowledge or information thereof sufficient to form a belief as to the allegation that said payment was made in order to avoid the penalties alleged to have been threatened by defendant and imposed by law for non-payment.

X. Answering the allegations of paragraph numbered "thirty-fourth" of the complaint, upon information and belief, de-
31 fendant denies that said tax of $173,579.72, or any part thereof, was illegal.

Wherefore defendant demands judgment dismissing the complaint herein together with the costs and disbursements of this action.

FRANCIS G. CAFFEY,
United States Attorney for the Southern District of New York,
Attorney for Defendant,

Office & P. O. address, U. S. Courts & Post Office Building, Borough of Manhattan, New York City.

[Jurat showing the foregoing was duly sworn to by W. H. Edwards. Omitted in printing.]

32 In United States District Court

[Title omitted.]

Minute entry

Douglas, Armitage & McCann, attorneys for the plaintiffs; William Hayward, United States attorney and Richard S. Holmes, assistant United States attorney, attorneys for the defendant.

Thereafter, on February 20, 1922, both sides consented to try the case by a jury of one.

Jury of one duly empanelled and sworn.

Facts agreed upon.

32a Each side moves for a direction of a verdict.

Thereafter, on December 19, 1922, by direction of the court, verdict for the defendant.

An extract from the minutes.

[SEAL.] ALEX. GILCHRIST, Jr., *Clerk.*

In United States District Court

[Title omitted.]

Douglas, Armitage & McCann, attorneys for plaintiffs; William Hayward, United States attorney, attorney for defendant; Richard S. Holmes, special assistant U. S. attorney; James J. Cosgrove, special attorney, Bureau of Internal Revenue, of counsel.

Memorandum opinion

MACK, circuit judge:

This suit is brought by the executors of James Douglas, deceased, to recover the sum of $173,579.72 assessed as income tax
32b against funds received by the decedent as part of so-called "depletion distributions" made by the Phelps Dodge Corporation to its shareholders in September and December, 1917. It is the contention of the plaintiffs that these distributions were not dividends in the ordinary course of the business, but were liquidating dividends specifically made from a depletion reserve set up by the corporation under the direction of, and in accordance with, the

regulations of the Treasury Department, and, therefore, constituted return of capital to its stockholders. The solicitor for the Commissioner of Internal Revenue rejected this contention on the ground that under section 31 (b) of the revenue act of 1916, added by section 1211 of the act of October 3, 1917, a corporation could not declare a dividend out of profits earned prior to March 1, 1913, or from a depletion reserve—and thereby enable the recipients to escape the tax thereon,—at a time when the company had earnings in its surplus fund which accrued to it on or after March 1, 1913, from which the dividend or dividends could have been paid, in any event not without a reduction of its capital stock.

Plaintiff's Exhibit D, which is annexed hereto as Schedule I, gives a summary of the changes in the financial condition of the Phelps Dodge Corporation during the period 1912–1917.

It appears therefrom that on March 1, 1913, the Phelps Dodge Corporation[1] had net assets aggregating $153,275,606.69; it
32c had capital stock outstanding of a par value of $45,000,000.-000.00 and surplus of $108,275,606.69, of which it is agreed $45,000,000.00 represented a paid-in surplus, leaving an earned surplus of $63,275,606.69.

The dividends distributed to the stockholders in 1913 exceeded the net profits of the corporation for that year by $1,051,883.14; in 1914 by $2,653,541.90; and in 1915 by $3,376,476.11. In 1916, however, the net profits exceeded the dividends by $3,125,621.67, and in 1917 the net profits exceeded the dividends, including the so-called depletion dividends, by $2,342,487.06.

It is the contention of the plaintiffs that the directors in each of these years believed they were paying dividends out of the company's net income, inasmuch as the depletion was taken on the books of the company at a considerably less amount than that ultimately allowed by the Government on March 2, 1920. Plaintiffs also point out that the total distributions to the stockholders during the years 1913 to 1917 exceeded the net income for those years on the basis of the depletion reserves allowed by the Government, by $1,616,000.00.

The dividends or distributions declared on September 13, 1917, and December 13, 1917, and payable on the 28th of these months, purported to be made from a depletion account. The resolutions authorizing the September distribution read as follows:

"Whereas this company, in accordance with the income tax section of the tariff act of 1913, and with the income tax law of September 8,
1916, has yearly, in computing its income, deducted therefrom
32d a reasonable allowance for depletion of its mines, based upon the fair market value thereof as of March 1, 1913; and

Whereas the income tax law and the rulings of the Department of Internal Revenue provide for a separation of said deductions from

[1] I refer to the Phelps Dodge Corporation throughout this opinion, disregarding change in name and corporate readjustments and consolidations not material for the disposition of this case.

income and provide further that payments to stockholders from said depletion account will be a return of capital invested, and are not subject to income tax in the hands of the shareholders;

Therefore, resolved that this company distribute among its stockholders from said depletion account three dollars a share, to be paid on September 28, 1917, to stockholders of record on September 24, 1917, the total amount so paid to be deducted from said depletion account."

The December resolution was identical in form.

These depletion dividends, when declared, were credited on the books of the corporation to a new account which was opened, entitled "Distribution from reserve for depletion," and when the dividends were paid, the cash account was credited and the account entitled "Distribution from reserve for depletion" was debited. Although the corporation had at the time two depletion accounts, one called the "Depletion reserve" and the other "Ore reserve," neither the regular "Depletion reserve" account nor the "Ore reserve" account was charged with the amount of the depletion dividends; no part thereof was deducted from either of these accounts upon the
32e books of the company, and the invested capital of the corporation was not reduced in the excess tax return filed by it, by the amount of any depletion dividends declared and paid in 1917; naturally no reduction in the capital stock of the corporation was thereby effected.

The so-called depletion dividend of September amounted to $1,350,000.00 and the plaintiffs' testator, Dr. James Douglas, received in respect of the 41,050 shares of the capital stock of the corporation held by him $123,150.000. The December dividend amounted to $2,250,000.00 and Dr. Douglas received $205,250.00.

Dr. Douglas, in his 1917 income tax return, included in his taxable income all dividends received from the corporation, except the two depletion dividends with reference to which he inserted the following note:

"NOTE.—In addition to the monies received during the year 1917 as reported in the foregoing individual income tax return for 1917, I have received the following amounts:

1917		
Sept. 28.	Rec'd as a stockholder from the Phelps Dodge Corporation, 99 John Street, New York, N. Y., a distribution from reserve from depletion	$123,150
Dec. 28.	Do	205,250
	Total	328,400"

(1) Plaintiffs, pointing out that the total earnings of the
32f company from March 1, 1913, to December 31, 1917, were $50,133,207.58; that the distributions made during the same period were $51,750,000.00, leaving an excess of distributions over earnings of $1,616,000.000, contend that in no circumstances can Dr. Douglas' share of $1,616,000.00 of the amount distributed as

depletion dividends in 1917 be regarded as taxable income accruing subsequent to March 1, 1913. The contention when analyzed, however, is clearly untenable. Although the directors may have distributed in dividends in 1913, 1914, and 1915 sums in excess of the net earnings for those years, the earned surplus accumulated by the corporation readily enabled them to do so. Under the income tax act of 1913 even these excess distributions from earnings accumulated prior to March 1, 1913, were subject to tax. Lynch v. Hornby, 247 U. S., 339. The law was changed in 1916 and dividends from surplus accumulated prior to March 1, 1913, were exempted from tax. Consequently, if in 1916 and 1917, the corporation had distributed as dividends sums in excess of their net earnings in those years, such excess would have been exempt. But, as has been indicated, the net earnings in both 1916 and 1917 exceeded all the distributions made in those years.

Inasmuch as the net income for 1913 to 1915 was less than the dividends of those years, the excess must have been paid from the surplus on hand March 1, 1913. It was, therefore, part of the dividends of these years and not the dividends of 1916 and 1917, that came from this surplus.

It follows that before December 31, 1915, there had been expended in dividends during 1913, 1914, and 1915, the entire net earn-
32g ings for those years and, in addition thereto, a part of the surplus accumulated prior to March 1, 1913.

If the dividends paid in the year 1916 are to be charged against the surplus theretofore accumulated and not against the current earnings of that year, the entire net earnings of that year, $17,750,621.67, would form part of the surplus as of December 31, 1916, an amount more than sufficient to pay both the dividends and depletion distributions made in 1917.

If, however, the dividends of 1916 are properly chargeable to the current net earnings of that year, then only $3,125,621.67 of the surplus as of December 31, 1916, would have come from the net earnings of 1916 or of the period subsequent to February 28, 1913. In that case, if the dividends paid in 1917 are not properly chargeable against the net earnings of that year, the ordinary dividends of 1917 paid prior to the depletion distributions would more than have exhausted this $3,125,621.67, and in that event plaintiff's contention that the depletion distribution necessarily came from surplus accumulated prior to March 1, 1913, would be sound.

(2) It is necessary, therefore, to consider next the interpretation of the act in question. And as to that (a) whether ordinary dividends are to be deemed payable only out of accumulated profits and surplus as shown by the last bookkeeping determination, or also, and in the first instance, either in whole or in part out of the current net earnings of the year in which they are paid, regardless of whether at the time of payment it shall have been actually and
32h finally determined by inventory and balancing of books that sufficient net profits therefor have been earned; (b) even if

ordinary dividends are chargeable first to current undetermined net earnings, whether depletion distributions, unlike such ordinary dividends, may nevertheless be paid out of a depletion reserve or out of surplus earned prior to March 1, 1913, as capital distributions, without reduction of the capital stock.

(a) Section 31 of the revenue act of 1916, as supplemented by the revenue act of 1917, reads as follows:

"SEC. 31(a) That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of the earnings or profits so distributed.

(b) "Any distribution" made to the shareholders or members of a corporation, joint-stock company or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which
32i received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen."

It seems to me that the congressional intent is clear. Distributions to shareholders are to be regarded as made from current earnings and the most recently accumulated surplus: Congress, in my judgment, did not intend to lay down a narrow rule to be whittled away by technical definitions of the terms surplus, undivided profits, dividends, and distributions. Nor did it intend to recite a mere prima facie rule which could be arbitrarily set aside by the form of the bookkeeping entries. It is to be assumed that Congress desired that, so far as possible, the tax should be regulated by the substance of things and not their form, and that taxation should not fall more lightly upon one man than upon another because of ingenuity in bookkeeping methods.

32j If plaintiffs' contention that "the most recently accumulated undivided profits or surplus" is necessarily limited to such profits and surplus as are definitely ascertained by closing the books, gross inequality might result dependent upon the number of times

in a fiscal year that the books are closed. Furthermore, if the contention were sound not merely as a construction of the act but—and plaintiffs so urge—as the proper relation of dividend distributions to earnings from the standpoint of sound accounting principles and usual business practice, it would be applicable also to the 1916 dividends. The result, as heretofore stated, would be that the entire large earnings of 1916 would be applicable to the 1917 distributions, both ordinary and depletion. True, in that case, there would be a recovery because the tax would have been assessable at 1916 instead of 1917 rates.

The practice, however, of this very corporation and of the deceased stockholder indicates what, in my judgment, is the sounder view. The company, in its annual report, while stating that the earliest dividends, paid in March, 1917, were paid out of profits accrued during the year 1916, declared that the regular ordinary and extra dividends—these do not include the depletion distributions—paid in June, September and December, 1917, were paid out of earnings for the year 1917. And Dr. Douglas, as heretofore stated, so returned them in his income tax report for the year 1917.

Though the books were not balanced and net profits carried into the undivided profits and surplus account at the time of the payment of any of these dividends, it was obvious, as it ordi-
32k narily would be, that large current profits were being made and distributed from time to time throughout 1917.

In my judgment, Congress did not intend, and there is nothing in the legislative history of the enactment of section 31 (b) reasonably considered that would indicate that Congress intended, to use the terms undivided profits or surplus in a strict technical sense which would exclude from their embrace current profits. If Congress had so intended, it would have resulted in nearly all corporate dividends declared in the war year 1917 being taxed at the lower rates prescribed for 1916 or not being taxed at all.

Subsequent legislation indicates not a change but a clarification of that legislative intent. Section 201 (b) of the revenue act of 1918 provided:

"Any distribution shall be deemed to have been made from earnings or profits unless all earnings and profits have first been distributed."

And the same numbered section of the revenue act of 1921 is expressive of the same intent.

"For the purposes of this act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits, accumulated since February 28, 1913, but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the
321 earnings and profits accumulated since February 28, 1913, have been distributed. If any such tax-free distribution has been made the distributee shall not be allowed as a deduction from

gross income any loss sustained from the sale or other disposition of his stock or shares, unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon."

That undivided profits as used in section 31 (b) was intended to include current profit earned during the current year, was certainly the contemporaneous construction placed upon it not only by Dr. Douglas, but by taxpayers generally. Furthermore, article 107 of Treasury Regulations 33, Revised, provided:

"Any distribution made to shareholders in the year 1917 or subsequent years (except any distribution of dividends made prior to August 6, 1917, out of earnings or profits accrued prior to Mar. 1, 1913) shall be deemed to have been made from the most recently accumulated undivided surplus or profits, and shall constitute income of the distributee for the year in which received, and shall be taxed to such distributee at the rates prescribed by law for the years in which such surplus or profits were earned by the distributing corporation.

Thus, if a corporation distributed dividends in 1917, such
32m dividends will be deemed to have been paid from the earnings of 1917, and the recipient, if an individual, will be liable to additional tax, if any, and if a corporation, to income tax, at the rates for the year 1917, unless it is shown to the satisfaction of the Commissioner of Internal Revenue that at the time such dividends were paid, the earnings up to that time were not sufficient to cover the distribution, in which case the excess over the earnings of the taxable year will be deemed to have been paid from the most recently accumulated surplus of prior years, and will be taxed at the rate or rates for the year or years in which earned.

A corporation declaring and paying dividends out of a surplus or earnings accumulated over a period of years, should make a record in its books of the amount of dividends paid out of each year's undistributed surplus or profits, and advise the stockholders accordingly, in order that the dividends received by them may be taxed at the respective rates prevailing during the years in which the surplus or profits so distributed were earned. * * *"

The Commissioner of Internal Revenue was not satisfied that at the time these so-called depletion dividends were paid, the earnings up to that time were not sufficient to cover such distribution. The audit of the 1917 books indeed proves that the net earnings of 1917 were more than sufficient to pay all the distributions made, and there is nothing to indicate that a pro rata apportionment thereof is not in accordance with the facts. Under such ap-
32n portionment the net earnings were sufficient at the respective times for all of the distributions.

(b) Depletion distributions without reduction of capital stock are not to be differentiated in the matters here under consideration from ordinary dividends. Depletion reserves are a mere bookkeeping account: the distribution comes from the general assets of the company: it results in a reduction thereof. If a similar reduction were made in the capital stock liability by some method permissible under the laws of the state of its creation, a different situation might be presented. But this was not done in the instant case. Calling the distribution of corporate assets a distribution of depletion reserve does not make it a payment of capital instead of income when there are net earnings or accumulated surplus sufficient to meet it. And in my judgment, the act is correctly interpreted in paragraph 26 of Regulation 33 of the Treasury, issued thereunder in January, 1918, reading as follows:

"Dividend from depletion reserve. A reserve set up out of gross receipts and maintained by a corporation for the purpose of making good any loss or wasting of capital assets on account of depletion is not to be considered a part of the earned surplus of the company, but a reserve for the return or liquidation of capital. A dividend paid from such reserve will be considered a liquidating dividend and will not constitute taxable income to the stockholder except to the extent that the amount so received is in excess of the capital actually invested by the stockholder in the shares of stock held by him, and with respect to which the distribution was made. No dividend will, however, be deemed to have been paid from such reserve except to the extent that such dividend exceeds the surplus and undivided profits of the corporation at the time of such payment and unless the books, records, published statements, etc., of the corporation clearly indicate a corresponding reduction of capital assets resulting from such payment."

Inasmuch as the net earnings for 1917 were at the time of these distributions, as heretofore stated, more than sufficient to meet them, the claim for refund was properly rejected. A verdict for the defendant will, therefore, be directed.

Since this opinion was prepared, my attention has been called by the defendant's counsel to the opinion of Judge Cooper in Harder v. Irwin, not yet reported, an opinion in which I entirely concur.

JULIAN W. MACK,
U. S. Circuit Judge.

DECEMBER 18, 1922.

SCHEDULE I

Plaintiff's Exhibit D to opinion

[PHELPS DODGE CORPORATION. Memorandum re changes in financial condition 1912–1917]

	1912	1913	1914	1915	1916	1917	Total
Income, before deducting depletion		$11,120,368.73	$8,216,266.66	$10,501,310.77	$23,675,783.01	$22,456,906.32	$75,970,635.49
Depletion, at Treasury Department's rates		4,747,251.87	4,572,808.56	4,877,786.88	5,925,161.34	5,714,419.26	25,837,427.91
Profit		6,373,116.86	3,643,458.10	5,623,523.89	17,750,621.67	16,742,487.06	50,133,207.58
Dividends paid from earned surplus		7,425,000.00	6,300,000.00	9,000,000.00	14,625,000.00	10,800,000.00	48,150,000.00
Distributions of proceeds of depletion						3,600,000.00	3,600,000.00
Total distributions to stockholders		7,425,000.00	6,300,000.00	9,000,000.00	14,625,000.00	14,400,000.00	51,750,000.00
Capital expenditures:							
Mines		678,121.98	183,796.91	488,141.54	1,508,138.54	3,796,653.03	6,287,558.18
Plants		1,088,392.37	1,435,008.46	1,668,945.69	1,508,655.32	1,414,682.28	7,115,684.12
Investments		136,386.38	390,213.44	4,393.00	249,101.17	585,267.02	77,945.79
Total capital expenditures		1,903,200.73	860,998.11	2,152,694.23	2,767,692.69	5,796,602.33	13,481,188.09
Balance sheets, 31st December:							
Mines	$132,285,000.00	128,216,170.11	123,459,564.64	119,069,919.30	114,652,896.50	112,735,130.27	
Plants	5,281,367.23	5,911,154.45	8,233,318.46	9,440,549.51	10,455,211.45	11,484,535.18	
Investments	3,151,535.24	3,287,921.62	2,897,708.18	2,893,315.18	2,644,214.01	3,129,481.03	
Current assets derived from depletion		4,068,829.89	8,825,435.36	13,265,080.70	17,632,103.50	15,949,869.73	
Current assets—other	12,557,704.22	10,739,647.48	6,131,155.01	1,521,840.85	3,931,901.75	8,359,798.06	
Total assets	153,275,606.69	152,223,723.55	149,567,181.65	146,190,705.54	149,316,327.21	151,658,814.27	
Capital stock	45,000,000.00	45,000,000.00	45,000,000.00	45,000,000.00	45,000,000.00	45,000,000.00	
Surplus:							
Prior to 1913	108,275,606.69	107,223,723.55	104,567,181.65	101,190,705.54	101,190,705.54	97,590,705.54	
Since 1912					3,125,621.67	9,068,108.73	
Total capital	153,275,606.69	152,223,723.55	149,567,181.65	146,190,705.54	149,316,327.21	151,658,814.27	

32q In United States District Court

Judgment

[Title omitted.]

The issues in this action having been regularly brought on for trial before honorable Julian W. Mack, United States Circuit judge, and a jury of one at a stated term of the United States District Court for the Southern District of New York, held on the 20th day of February, 1922, at the United States Courts and Post Office Building in the Borough of Manhattan, city, county, State and Southern District of New York, and plaintiffs having appeared herein by Douglas, Armitage & McCann, their attorneys, Matthew C. Fleming, Esq., of counsel, and defendant having appeared by William Hayward, United States attorney for the Southern District of New York, his attorney, Richard S. Holmes, special assistant United States attorney, of counsel, and the allegations and
32r proofs of the parties having been heard and considered, and at the close of the testimony for both sides the attorneys for the plaintiffs and the defendant having moved for the direction of a verdict, and the honorable court on the 18th day of December, 1922, having granted the motion in favor of the defendant and having directed a verdict in favor of said defendant and the verdict having been entered accordingly, and the costs of said defendant having been taxed in the sum of $21.15,

Now, on motion of William Hayward, United States attorney for the Southern District of New York, attorney for defendant, it is

Adjudged that the complaint herein be, and it hereby is, dismissed upon the merits and that defendant have and recover of the plaintiffs the sum of $21.15 his costs as taxed and that said defendant have execution against said plaintiffs therefor.

Judgment signed this 22nd day of December, 1922.

ALEX. GILCHRIST, JR., *Clerk.*

32s In United States District Court

Bill of exceptions

[Title omitted.]

Caption

Be it remembered that afterward, to wit, on the twenty-second day of December, in the year of our Lord, one thousand nine hundred and twenty-one, at a stated term of the said court, begun and holden in New York, in and for the Southern District of New York, before his honor, Julian W. Mack, circuit judge, the issue joined in the

above entitled cause between the said parties, came on to be tried before the said judge, and it was adjourned until the 20th day of February, 1922, and on the said day the parties aforesaid by their consent according to the statute made and in such cases provided, duly stipulated and agreed to try the said case by a jury of
32t one, which was thereupon duly empanelled and sworn. The plaintiffs being represented by Douglas, Armitage & McCann, by Matthew Corry Fleming, Esq., Archibald Douglas, Esq., Paul Armitage, Esq., Edward Holloway, Esq., of counsel, and the defendant by William Hayward, United States attorney, by Richard S. Holmes, Esq., ass't U. S. attorney; by James J. Cosgrove, special attorney, Bureau of Internal Revenue, and upon the trial of the issues, the said attorneys thereupon entered into the following stipulation for the purpose of this suit only, to wit:

Stipulation of facts

1. That either party may, upon any trial or hearing of this suit and upon any motion, appeal or other proceeding or hearing arising therefrom, cite or refer to any of the regulations issued by the Treasury Department. The dates affixed to such papers shall be deemed to be the dates on which they were officially promulgated.

2. That for the purposes of this suit they admit as facts the following statements, subject, however, to any objections by any party to the materiality and relevancy as evidence of any or either
33 of the facts so admitted. Subject to such objections, the said statements shall, upon any trial or hearing of this suit and upon any motion, appeal or other proceeding therein or arising therefrom, be used as competent proof of the facts stated, and with the same force and effect as if all the facts therein stated had been duly proved by competent evidence in accordance with the statutes in such case made and provided and with the rules and practice of the United States courts.

3. That any party to this suit may introduce any other or further evidence, oral or written, which he may deem material or relevant to any of the issues raised in this suit, subject to objections by the other parties as to the competency, relevancy, or materiality of such evidence, it being the intention that this stipulation shall in no way preclude any of the parties from offering any evidence which they may wish to offer upon any of the matters relevant to the issues in this suit.

4. That Archibald Douglas, George Notman, and Edmund Coffin, at all the times mentioned in the complaint, were and now are citizens of the United States and residents of the State of New York, and of the 14th, 1st, and 2nd United States internal revenue districts of the State of New York, respectfully.

5. That James Douglas, died on June 25, 1918, a resident of the Borough of the Bronx, county of Bronx, city of New York, and State and Southern District of New York.

6. That the last will and testament of said James Douglas and three codicils thereto were duly admitted to probate on
34 August 27, 1918, by the surrogate of Bronx County. That Archibald Douglas, George Notman, and Edmund Coffin were duly appointed executors thereof by the surrogate of the county of the Bronx, State of New York, on said 27th day of August, 1918, and have duly qualified and are now acting as such executors.

7. That the defendant, William H. Edwards, is a resident and inhabitant of the Borough of Manhattan, city, county, and State and Southern District of New York, and was from the 8th day of April, 1917, and at the time of the commencement of this action was the collector of the United States internal revenue for the second district of New York.

8. That on March 1, 1913, James Douglas was the owner and holder of 41,025 shares of capital stock of Phelps Dodge & Company, Inc., hereinafter described; that on July 2, 1913, he purchased 25 additional shares of such stock for the sum of $2,500; that on April 1, 1917, said James Douglas, pursuant to the transaction hereinafter set forth, exchanged said 41,050 shares of the capital stock of Phelps Dodge & Co., Inc., for 41,050 shares of the capital stock of Phelps Dodge Corporation, hereinafter more fully described; that at the time of his death on June 25, 1918, he was the owner and holder of said 41,050 shares of the capital stock of said Phelps Dodge Corporation, so received in exchange.

9. That on the 1st day of March, 1913, the said 41,050 shares of stock of Phelps Dodge & Company, Inc., so held by the said James Douglas were of the value of at least $8,717,812.50.

35 10. That the said Phelps Dodge & Company, Inc., was at all times hereinafter mentioned and prior to the 1st day of April, 1917, a corporation organized on the 14th day of December, 1908, and existing under the laws of the State of New York, with an authorized capital stock of $50,000,000, of which $45,000,000 was issued and outstanding, with a principal place of business at 99 John Street, in the Borough of Manhattan, city and State of New York.

11. That on and prior to the 13th day of March, 1917, Copper Queen Consolidated Mining Company was a corporation organized on the 10th day of August, 1885, and existing under the laws of the State of New York, with an authorized capital stock of $2,000,000, all of which was issued and outstanding on March 13, 1917.

12. That on and prior to the 31st day of March, 1917, Detroit Copper Mining Company of Arizona was a corporation organized on the 24th day of September, 1872, and existing under the laws of the State of Michigan, having an authorized capital stock of $1,000,000, all of which was issued and outstanding on March 31, 1917.

13. That on and prior to the 31st day of March, 1917, Moctezuma Copper Company was a corporation, organized on the 17th day of September, 1895, and existing under the laws of the State of West

Virginia, with an authorized capital stock of $3,000,000, of which $2,600,000 was then issued and outstanding on March 31, 1917.

14. That on and prior to the 31st day of March, 1917, Burro
36 Mountain Copper Company was a corporation organized on the 20th day of January, 1904, and existing under the laws of the State of New Mexico, with an authorized capital stock of $8,000,000, all of which was then issued and outstanding on March 31, 1917.

15. That on and prior to the 31st day of March, 1917, Stag Canon Fuel Company was a corporation organized on the 8th day of December, 1905, and existing under the law of the State of New Mexico, with an authorized capital stock of $3,000,000, all of which was then issued and outstanding on March 31, 1917.

16. That on and prior to the 31st day of March, 1917, Bunker Hill Mines Company was a corporation organized on the 3rd day of November, 1909, and existing under the law of the State of West Virginia, with an authorized capital stock of $1,000,000, of which $750,000 was then issued and outstanding on March 31, 1917.

17. That on and prior to the 31st day of March, 1917, Phelps Dodge Mercantile Company was a corporation organized on the 18th day of December, 1911, and existing under the law of the State of New York, with an authorized capital stock of $4,000,000, of which $2,000,000 was then issued and outstanding on March 31, 1917.

18. That on and prior to the 1st day of March, 1913, the said Phelps Dodge & Company, Inc., was the owner and holder of all the capital stock issued and outstanding of the Copper Queen Consolidated Mining Company, the Detroit Copper Mining Company of Arizona, Burro Mountain Copper Company, Stag Canon
37 Fuel Company, Moctezuma Copper Company, Bunker Hill Mines Company, and Phelps Dodge Mercantile Company, hereinafter known as subsidiaries.

19. That on the 13th day of March, 1917, the capital stock of Copper Queen Consolidated Mining Company was duly increased to the sum of $50,000,000, divided into 500,000 shares, with a par value of $100 per share, by certificate of increase filed in the office of the secretary of state of New York on the 13th day of March, 1917.

20. That on the 14th day of March, 1917, the Copper Queen Consolidated Mining Company, by order of the Supreme Court of the State of New York, duly made and entered on the 5th day of February, 1917, in the office of the clerk of the county of New York, changed its name to Phelps Dodge Corporation.

21. That on or about the 1st day of April, 1917, Phelps Dodge & Co., Inc., assigned and transferred the entire capital stock of Detroit Copper Mining Company of Arizona, Stag Canon Fuel Company, Burro Mountain Copper Company, Moctezuma Copper Company, and Phelps Dodge Mercantile Company to Phelps Dodge Corporation, and Phelps Dodge Corporation executed and delivered to Phelps

Dodge & Company, Inc., its evidence of indebtedness in the sum of $73,000,000.

22. That on or about the 1st day of April, 1917, Phelps Dodge & Company, Inc., assigned, transferred and set over all its remaining assets (exclusive of $2,000,000 capital stock of Phelps
38 Dodge Corporation and a sufficient sum to meet liabilities) for the sum of $1,450,000, and Phelps Dodge Corporation executed and delivered its evidence of indebtedness for the sum of $1,450,000 to Phelps Dodge & Company, Inc.

23. That on or about the 1st day of April, 1917, Phelps Dodge & Company, Inc., duly transferred, assigned and delivered to Phelps Dodge Corporation evidence of indebtedness of Phelps Dodge Corporation, amounting to the sum of $74,450,000, in exchange for $43,000,000 of the capital stock of Phelps Dodge Corporation.

24. That on or about the 1st day of April, 1917, Phelps Dodge & Company, Inc., duly dissolved and distributed to its shareholders in liquidation its sole assets, consisting of $45,000,000 of capital stock of Phelps Dodge Corporation, share for share, in exchange for its outstanding capital stock of $45,000,000.

25. That on or about the 10th day of April, 1917, Detroit Copper Mining Company of Arizona, Burro Mountain Copper Company, and Stag Canon Fuel Company transferred, assigned, and set over in liquidation to its stockholder, the Phelps Dodge Corporation, all of its property and assets, and its stockholder, Phelps Dodge Corporation, in exchange therefor transferred to each of the said companies all of its issued and outstanding capital stock.

26. That subsequent to the 1st day of March, 1913, and prior to the 1st day of April, 1917, the Copper Queen Consolidated Mining Company, the Detroit Copper Mining Company of Arizona, Burro
39 Mountain Copper Company, Stag Canon Fuel Company, Moctezuma Copper Company, Bunker Hill Mines Company, and subsequent to the 31st day of March, 1917, and prior to the 28th day of December, 1917, the Phelps Dodge Corporation, Moctezuma Copper Company, and Bunker Hill Mines Company mined and extracted copper ore from the mines and the ore bodies that were known probable or prospective ore, as of February 28, 1913, and sold copper and copper ore so produced.

27. That for a long time prior to the 1st day of March, 1913, the Copper Queen Consolidated Mining Company, the Detroit Mining Company of Arizona, Burro Mountain Copper Company, Stag Canon Fuel Company, and Moctezuma Copper Company were the owners and holders and operators in their own names of various valuable copper mines containing copper ore.

28. That the Commissioner of Internal Revenue, on December 1, 1919, made a provisional valuation, for depletion and other purposes, as shown by Exhibit A, attached hereto, of the various mining

properties owned by the said subsidiaries of Phelps Dodge Corporation, Inc., as of March 1, 1913, as follows:

Cooper Queen limestone (copper)	$65, 369, 000
Copper Queen porphyry mines (copper)	15, 355, 000
Moctezuma mines (copper)	25, 260, 000
Burro Mountain mines (copper)	6, 269, 000
Morenci mines (copper)	8, 832, 000
Total value copper mines, March 1, 1913	121, 085, 000
Value of Stag Canon coal mines	11, 200, 000
Total value fixed by bureau as of March 1, 1913, all company's mines	132, 285, 000

That upon the basis of the above valuation the income and excess profits tax returns of Phelps Dodge Corporation, for the year 1917 and 1918, were audited and closed by the Commissioner of Internal Revenue and the tax paid.

29. That in the years 1913 to 1917, inclusive, there was mined from the above mentioned mines copper ore and coal which the said Copper Queen Consolidated Mining Company, the Detroit Copper Mining Company of Arizona, Burro Mountain Copper Company, Stag Canon Fuel Company, and Moctezuma Copper Company owned in March 1, 1913, from which were produced the following (copper is given in pounds; coal in tons):

	Copper Queen Mining Co.	(Morenci) Detroit Copper Mining Co.	Burro Mountain Mining Co.
1913	85, 394, 828	24, 931, 426	
1914	76, 842, 973	20, 265, 994	
1915	86, 912, 528	15, 321, 867	
1916	95, 397, 219	17, 585, 608	6, 974, 965
1917	89, 315, 717	13, 195, 495	13, 107, 754
Total	433, 863, 265	91, 300, 390	20, 075, 719

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	Moctezuma Mines Company	Stag Canon Fuel Co. (Coal)
1913	36, 598, 132	1, 322, 813
1914	21, 621, 566	1, 355, 338
1915	23, 104, 609	1, 265, 674
1916	36, 254, 493	1, 439, 904
1917	36, 712, 433	1, 406, 079
Total	154, 291, 233	6, 789, 808

30. That based on the above provisional valuation and the above tonnage of copper and coal extracted during the years 1913 and 1917, the Commissioner of Internal Revenue fixed the depletion of the said several companies for the years 1913 to 1917, inclusive,

and the amount of depletion so fixed and the amount set up on the books of said companies are as follows:

COPPER QUEEN MINING COMPANY (DEPLETION)

	As per books	As fixed by Treasury Department
1913	$524, 469. 20	$2, 924, 762. 89
1914	411, 270. 35	3, 158, 244. 55
1915	534, 563. 79	3, 572, 144. 82
1916	3, 382, 246. 75	3, 920, 825. 70
1917	3, 065, 500. 20	3, 670, 875. 97
Total	7, 948, 050. 29	17, 246, 853. 93

DETROIT COPPER MINING COMPANY (MORENCI)

1913	$108, 321. 47	$644, 061. 89
1914	86, 652. 65	628, 245. 81
1915	87, 411. 33	474, 977. 88
1916	409, 407. 00	545, 153. 85
1917	290, 817. 51	409, 060. 34
Total	982, 609. 95	2, 701, 499. 77

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BURRO MOUNTAIN COPPER COMPANY

1913		
1914		
1915		
1916		
1917		$184, 139. 08
	$476, 075. 00	346, 044. 70
Total	476, 075. 00	530, 183. 78

MOCTEZUMA COPPER COMPANY

1913	$164, 654. 80	$1, 009, 498. 53
1914	122, 301. 14	715, 673. 83
1915	125, 699. 80	764, 762. 56
1916	2, 715, 289. 00	1, 200, 023. 72
1917	1, 613, 830. 00	1, 215, 181. 53
Total	4, 741, 774. 74	4, 905, 140. 17

STAG CANON FUEL COMPANY

1913	$56, 204. 10	$68, 918. 56
1914	36, 610. 32	70, 644. 37
1915	33, 160. 32	65, 941. 62
1916	71, 995. 20	75, 018. 99
1917	70, 303. 96	73, 256. 72
Total	268, 273. 90	353, 780. 26

TOTAL AS TO YEARS

	As per books	As fixed by Treasury Department
1913	$853, 649. 57	$4, 747, 251. 87
1914	686, 834. 45	4, 572, 808. 56
1915	780, 835. 24	4, 877, 786. 88
1916	6, 578, 937. 95	5, 925, 161. 34
1917	5, 516, 526. 67	5, 714, 419. 26
	14, 416, 783. 88	25, 837, 427. 91

43 31. That the above amounts were reached by multiplying the number of units of copper and coal extracted in each of the above years by the unit depletion values fixed by the Bureau of Internal Revenue in accordance with the above valuations as of March 1, 1913, and that in adjusting income and excess profits taxes of the company for the years 1913–1918 the above depletion allowances were used as factors by the Bureau of Internal Revenue. That the 1917 income and excess profits taxes of the company were finally determined on or about March 1, 1920.

32. That on September 13, 1917, at a meeting of the board of directors of Phelps Dodge Corporation, the following preamble and resolution was adopted:

"Whereas, this company in accordance with the income tax section of the tariff act of 1913 and with the income tax law of September 8, 1916, has yearly, in computing its income, deducted therefrom a reasonable allowance for depletion of its mines, based upon the fair market value thereof as of March 1, 1913; and

"Whereas, the income tax and the ruling of the Department of Internal Revenue provide for a separation of said deductions from income and provide further that payments to stockholders from said depletion account will be a return of capital invested, and are not subject to income tax in the hands of the shareholders:

"Therefore, resolved, That this company distribute among
44 its stockholders from said depletion account, three dollars a share, to be paid on September 28, 1917, to stockholders of record on September 24, 1917, the total amount so paid to be deducted from said depletion account."

33. That the distributions so authorized were duly paid to the stockholders of record of Phelps Dodge Corporation, and that on September 28, 1917, James Douglas received $123,150 as his proportionate share in such distribution.

34. That the directors of Phelps Dodge Corporation, at a meeting held on December 13, 1917, adopted the following preambles and resolutions:

"Whereas this company in accordance with the income tax section of the tariff act of 1913, and with the income tax law of September 8, 1916, has yearly, in computing its income, deducted therefrom a reasonable allowance for depletion of its mines, based upon the fair market value thereof as of March 1, 1913; and

"Whereas the income tax law and the rulings of the Department of Internal Revenue provide for a separation of said deductions

from income and provide further that payments to stockholders from said depletion account will be a return of capital invested and are not subject to income tax in the hands of the shareholders:

"Therefore, resolved, That this company distribute among its stockholders from said depletion account five dollars per share,
45 to be paid on December 28, 1917, to stockholders of record on December 18, 1917, the total amount so paid to be deducted from said depletion account."

35. That hereafter the distribution so authorized was paid to the stockholders of record of Phelps Dodge Corporation, and James Douglas received on December 28, 1917, $205,250, as his proportionate share of such distribution.

35A. That after the declaration of the depletion dividends in question there was no reduction of the share of capital stock of Phelps Dodge Corporation.

36. That during the calendar years 1913 to 1916, inclusive, the net income of Phelps Dodge & Co., Inc., before deducting depletion, was as follows:

1913	$11, 120, 368. 73
1914	8, 216, 266. 66
1915	10, 501, 310. 77
1916	23, 675, 783. 01
That during the year 1917 the net income of Phelps Dodge Corporation, before deducting depletion, was as follows:	
1917	22, 456, 906. 32
	75, 970, 635. 49

37. That the said net income for each company for each year could not be determined definitely until after the end of each year.

38. That during the calendar years 1913 to 1916, inclusive, Phelps Dodge & Co., Inc., distributed the following amounts to its stockholders:

46 1913	$7, 425, 000
1914	6, 300, 000
1915	9, 000, 000
1916	14, 625, 000
1917 (Phelps Dodge Corporation)	14, 400, 000
	51, 750, 000

Dividends paid by subsidiary companies to Phelps Dodge & Co., Inc., and Phelps Dodge Corporation, 1909 to 1917, inclusive

TO PHELPS DODGE & CO., INC.

Year	Copper Queen Mining Co.	Detroit Copper Mining Company	Stag Canon Fuel Co.
1909	$4, 021, 354. 50	$760, 000. 00	
1910	6, 299, 815. 00	1, 840, 000. 00	$180, 000. 00
1911	5, 200, 000. 00	800, 000. 00	240, 000. 00
1912	5, 707, 351. 23	1, 464, 610. 45	414, 926. 96
1913	5, 700, 000. 00	780, 000. 00	180, 000. 00
1914	4, 500, 000. 00	280, 000. 00	
1915	7, 000, 000. 00	920, 000. 00	
1916	14, 000, 000. 00	1, 000, 000. 00	120, 000. 00
	52, 428, 520. 73	7, 844, 610. 25	1, 134, 926. 96

Dividends paid by subsidiary companies to Phelps Dodge & Co., Inc., and Phelps Dodge Corporation, 1907 to 1917, inclusive—Continued

TO PHELPS DODGE & CO., INC.—Continued

Year	Moctezuma Copper Co.	Mercantile	Totals
1909	$988, 000. 00		$5, 769, 354. 50
1910	468, 000. 00		8, 787, 815. 00
1911	754, 000. 00		6, 994, 000. 00
1912	2, 118, 569. 58	$300, 000. 00	10, 005, 458. 02
1913	1, 950, 000. 00	500, 000. 00	9, 110, 000. 00
1914	1, 170, 000. 00	400, 000. 00	6, 350, 000. 00
1915	1, 534, 000. 00	500, 000. 00	9, 954, 000. 00
1916	3, 380, 000. 00	600, 000. 00	19, 100, 000. 00
	12, 362, 569. 58	2, 300, 000. 00	76, 070, 627. 52

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TO PHELPS DODGE CORPORATION

Year	Moctezuma Copper Co.	Mercantile	Totals
1917	$1, 950, 000. 00	$500, 000. 00	$2, 450, 000. 00

9 YEARS

Copper Queen Mining Co	$52, 428, 520. 73
Detroit Copper Mining Co	7, 844, 610. 25
Stag Canon Fuel Co	1, 134, 926. 96
Moctezuma Copper Co	14, 312, 569. 58
Mercantile	2, 800, 000. 00
Totals	78, 520, 627. 52

39. That during the calendar year 1917 the following amounts were distributed to stockholders:

PHELPS DODGE & CO., INC.

Div., 2½%	$1, 125, 000	
Paid Mar. 29, 1917, extra, 3½%	1, 575, 000	
		$2, 700, 000

PHELPS DODGE CORPORATION

Div., 2½%	$1, 125, 000	
Paid June 28, 1917, extra, 5½%	2, 475, 000	
		3, 600, 000
Div., 2½%	1, 125, 000	
Paid Sept. 28, 1917, extra, 2½%	1, 125, 000	
Res. for D., 3%	1, 350, 000	
		3, 600, 000
Div., 2½%	1, 125, 000	
Paid Dec. 28, 1917, extra, 2½%	1, 125, 000	
Res. for D., 5%	2, 250, 000	
		4, 500, 000
		14, 400, 000

the 8100000 includes all but X

39A. It is stipulated that the invested capital (as defined in section 207 of the revenue act of 1917) of the Phelps Dodge Corporation was not reduced in the excess profits tax return filed by the said company by the amount of any of the dividends declared and paid in 1917, as above set forth. Attached here as Exhibit R
48 is a copy of the annual report of the Phelps Dodge Corporation for the year 1917, as issued to its stockholders.

40. That Phelps Dodge Corporation as of April 2, 1917, took over and set up on its books certain "depletion reserve" account which were on the books of the following corporations: Copper Queen Consolidated Mining Company (Morenci Branch), Burro Mountain Mining Company, Stag Canon Fuel Company (Dawson Fuel Company), all of the capital stock of which was owned by Phelps Dodge & Company, Inc. The Moctezuma Copper Company, a subsidiary company of the Phelps Dodge Corporation, set up on its books a "depletion reserve" account. These accounts represented the depletion which had been set up on the books of the several companies for ores extracted prior to the first day of April, 1917 (Exhibits K, M, & P).

In addition to the above, additional accounts captioned "ore reserves," representing a so-called "realized depletion," were set up on the books of the above companies as per Exhibits L & Q.

On September 13, 1917, a dividend was declared of $1,350,000, payable September 28, 1917.

On December 13, 1917, a dividend was declared of $2,250,000, payable December 28, 1917.

Phelps Dodge Corporation set up on its books as of September 26, 1917, an account payable entitled "distribution from reserve for depletion," which was credited with these dividends as of the dates payable, and in addition to the aforesaid depletion reserve accounts, which had been set up a record of the annual depletion
49 sustained, an additional account entitled "Reserve for depletion" was opened, which was debited with the dividends of September, 1917, and December, 1917, and said account entitled "Reserve for depletion" has not been closed (Exhibit J).

These dividends have not been charged to the first mentioned "depletion reserve" account or "ore reserve account" set up on the books as of April, 1917 (Exhibits K, L, M, P, and Q).

That when said distributions were paid in cash the amount was credited to the "Cash account" on the books of said Phelps Dodge Corporation and debited to the said account entitled "Distribution from reserve for depletion."

41. That for the purpose of this action, it is stipulated that the value of the assets transferred to Phelps Dodge & Co., Inc., in December, 1908, was approximately $90,000,000 net.

That for these assets $45,000,000 of the capital stock of the corporation was issued and that the value to the said corporation of said assets was $90,000,000 of which $66,000,000 was the value of the mines.

42. That there had been no resolution of the board of directors specifically distributing capital, either by dividends or otherwise, of Phelps Dodge Corporation or Phelps Dodge & Co., Inc., or any of their subsidiaries prior to 1917.

43. That of the above distribution in 1917 by Phelps Dodge Corporation to its stockholders, the only amount specifically declared to be a distribution of the depletion account was the $3,600,000 purporting to be paid from depletion reserve in the year 1917 as set up on the books of the company.

50 44. That on March 28, 1918, James Douglas duly filed his income tax return with the defendant, to which return a statement was attached as follows:

"NOTE.—In addition to the monies received during the year 1917 as reported in the foregoing individual income tax return for 1917, I have received the following amounts:

1917		
Sept. 28.	Rec'd as a stockholder from the Phelps Dodge Corporation, 99 John Street, New York, N. Y., a distribution from reserve from depletion	$123,150
Dec. 28.	Do	205,250
	Total	328,400"

45. That at all times hereinafter mentioned the Phelps Dodge Corporation was and is a going concern.

46. That on an audit of the tax return for the year 1917, filed by James Douglas, his executors, the plaintiffs herein, were duly notified by the Commissioner of Internal Revenue on February 20, 1919, that the amount of $329,605 of which sum the said $328,400 formed a part, was income for the year 1917 and included in the said income were the two dividends so paid by the said Phelps Dodge Corporation, and that such dividends were taxable as income, and that thereupon a tax of $173,579.72 based on such claim of

51 additional income was assessed against plaintiffs. That plaintiffs were notified by defendant that failure to pay the said sum would cause a 5 per cent penalty to accrue, together with interest at 1 per cent per month from the date the defendant claimed such tax due until paid.

47. That plaintiffs duly paid a tax on May 16, 1919, of $173,579.72 so claimed by defendant to be due, which payment was made under written protest and to avoid threatened penalties.

48. That on November 24, 1919, plaintiffs filed a written claim for refund of the sum of $173,579.72 so paid on form 46, with the Commissioner of Internal Revenue, demanding the refunding of the said sum as a tax illegally and improperly assessed and collected.

49. That said claim for refund was rejected in writing by the Commissioner of Internal Revenue on the 19th day of April, 1920, and no part of the said sum of $173,579.72 has been refunded or repaid.

50. That Exhibit A is a copy of a statement fixing the provisional valuation of the mines of the Phelps Dodge Corporation and its

subsidiaries as of 1917, together with depletion statement signed by J. C. Dick, head of the mines valuation section, and L. C. Graton, valuation engineer of the Bureau of Internal Revenue, Treasury Department, dated December 1, 1919; and it is further stipulated that the same is a true copy of the original signed statement.

51. It is further stipulated that Exhibits A to R, inclusive, are true and correct copies of documents relative to this action,
51a and are admitted as exhibits herein, subject to paragraphs 1, 2, and 3.

52. It is further stipulated that the exhibits attached to the complaint as filed in this action, are true and correct copies of the original documents and are hereby made a part of this stipulation.

The attorneys for the plaintiffs offered in evidence the following papers and exhibits:

1. The income and excess profits tax return of the Phelps Dodge Corporation for the year 1917 (plaintiffs' Exhibit S).

2. A "Memorandum from the files" which was handed to Matthew C. Fleming, Esq., on January 27, 1922, by the head of the division of natural resources of the Bureau of Internal Revenue, which was used as one of the bases of calculating the Phelps Dodge Corporation tax (plaintiff's Exhibit T).

3. A letter from the Treasury Department, signed by Mr. Newton, acting assistant to the commissioner, dated March 2, 1920, fixing the income and the invested capital of the Phelps Dodge Corporation for the year 1917 (plaintiffs' Exhibit U).

4. A letter from the Deputy Commissioner of Internal Revenue, dated July 14, 1917, to the effect that distribution of depletion reserve is a return of capital and not taxable. Whereupon
51b counsel for the defendant did then and there insist before said judge that the said exhibit should not be allowed on the ground that the same was not material or relevant or competent, and prayed the said court not to admit and allow the same, and the said judge did then and there refuse to allow and admit the said exhibit to be introduced; whereupon counsel for said plaintiffs did then and there propose the exception to the ruling of said court, and prayed that this bill of exception might be sealed and it is hereby sealed accordingly.

JULIAN W. MACK. (L. S.)

Statement re offers in evidence

5. A statement of the separate earnings and depletion and dividends of the Copper Queen Consolidated Mining Company for the years 1913 to 1916, inclusive (plaintiffs' Exhibit V).

6. A letter from the Acting Commissioner of Internal Revenue addressed to Matthew C. Fleming, esq., as counsel for Phelps Dodge Corporation, on May 3, 1921 (plaintiffs' Exhibit W).

7. Two notices sent to stockholders accompanying September and December distribution of depletion reserve (plaintiffs' Exhibits X and Y).

8. Checks of Phelps Dodge Corporation to the order of James Douglas, being two checks dated September 28, 1917, one marked "Dividend No. 2 and extra" and the other "Distribution
51c from reserve for depletion" and two checks dated December 28, 1917, one of them marked "Dividend No. 3 and extra" and the other "Distribution No. 2 from reserve for depletion" (plaintiffs' Exhibit Z).

9. A memorandum showing how the depletion reserve amount which appears on page 8 of the company's annual report for the year 1917, being plaintiffs' Exhibit R, appears as $41,657,487.95 after deducting $3,600,000 distributed to the stockholders from depletion reserve (plaintiffs' Exhibit A 1).

10. Letter of the solicitor of internal revenue giving the ground on which the claim was rejected (plaintiffs' Exhibit A 2).

It was thereupon stipulated by the attorneys that either party may refer to any Treasury decision or to any regulation or to any ruling of the Commissioner of Internal Revenue approved by the Secretary of the Treasury.

It was thereupon conceded by the attorneys for the respective parties that the fiscal year of Phelps Dodge Corporation was the calendar year, for the years in question and thereupon plaintiffs rested their case.

Thereupon the attorneys for the said defendant, William H. Edwards, collector of internal revenue for the second district, New York, offered in evidence the following papers:

1. Certified photostatic copy of the return of Dr. James Douglas, with the exhibits annexed thereto (defendant's Exhibit No. 1).

51d 2. Certified photostatic copy of the claim for refund filed by the plaintiffs in this case for the taxes involved (defendant's Exhibit No. 2) and thereupon said defendant rested his case.

Motions for directed verdict

Thereupon plaintiffs formally moved for a direction of a verdict in their favor, upon which motion the court reserved decision.

Thereupon the defendant moved for the direction of a verdict, upon which the court reserved decision.

Thereafter and on the 18th day of December, 1922, the said Hon. Julian W. Mack, judge, directed a verdict in favor of the defendant and refused to direct a verdict in favor of the plaintiffs. The counsel for the plaintiffs did then and there except to the direction of a verdict for the said defendant, and prayed that their bill of exceptions be allowed and might be sealed and it is sealed accordingly.

JULIAN W. MACK. (L. S.)

And thereupon the counsel for the said plaintiffs then and there did except to the refusal of the said court to a direction of the

verdict in favor of the plaintiffs and prayed that their exceptions be allowed and might be sealed and it is hereby sealed accordingly.

JULIAN W. MACK. (L. S.)

Verdict

Thereupon the jury rendered a verdict in favor of the defendant. The foregoing bill of exceptions contains all of the evidence received upon the trial of this action, relating to the foregoing exceptions.

52 *Order settling bill of exceptions*

The attorneys for the plaintiffs in error and the plaintiffs above having thereupon tendered this as the plaintiffs' bill of exceptions to the rulings of the court upon the trial of this action, and having requested that the signature and seal of the trial judge aforesaid should be annexed to the same pursuant to that statute in such cases made and provided: and for as much as none of such matters and exceptions so offered and made to the ruling and direction of said judge, and none of the evidence and other things do appear upon the record of the said case, the said judge, pursuant to said request, did put his signature and seal to this bill of exceptions this 16th day of May, 1923.

[SEAL OF THE COURT.] JULIAN W. MACK,
Trial Judge.

PLAINTIFFS' EXHIBIT A

PHELPS DODGE CORPORATION 1917 TAXES VALUATIONS

Fair market values of company's mines have been approximated separately, viz:

Copper Queen lime deposit	$65,369,000.00
Copper Queen porphyry	15,355,000.00
Moctezuma	25,260,000.00
Burro Mountain	6,269,000.00
Morenci	8,832,000.00
Total	121,085,000.00
53 To this I have added the company's figures as fair market value of Stag Canon property	11,200,000.00
Total value of deposits exclusive of plant and equipment	132,285,000.00

Depletion

Provisional depletion for 1917 by unit method, $5,714,420.26.

As to the value of the deposits in the year 1908, it might be fair to assume that the properties would measure up in 1908 about as well as in 1913, and that from this total valuation of $132,285,000

by deducting the Copper Queen porphyry deposit of which little was known at that time, and also the Burro Mountain deposit would leave the probable value of the deposits in 1908 in the neighborhood of $110,000,000.00.

(Signed) J. C. DICK,
Head Metals Valuation Section.
(Signed) L. C. GRATON,
Valuation Engineer.

DEC. 1, 1919.

54 PLAINTIFFS' EXHIBIT B

Reserves for depletion, per books, 1920

[Phelps Dodge Corporation, combined]

	Stag	Copper Queen	Morenci	Burro	Total P. D. Co.	Moctezuma	Total combined
1913	56, 204. 10	824, 469. 20	108, 321. 47			164, 654. 80	853, 649. 57
1914	36, 610. 32	441, 270. 35	86, 652. 64			122, 301. 14	686, 834. 45
1915	33, 160. 66	534, 563. 79	87, 411. 33			125, 699. 80	780, 835. 58
1916	71, 995. 20	3, 362, 246. 75	409, 407. 00			2, 715, 280. 00	6, 578, 937. 95
1917	70, 303. 96	3, 065, 500. 20	290, 817. 51	476, 075. 00		1, 613, 830. 00	5, 516, 526. 67
1918	66, 780. 49	3, 005, 610. 30	417, 979. 32	582, 981. 00	4, 073, 351. 11	1, 589, 462. 00	5, 662, 813. 11
1919	44, 679. 24	2, 373, 216. 22	354, 323. 83	149, 657. 98	2, 921, 877. 27	876, 471. 22	3, 798, 348. 49
	379, 733. 97	13, 326, 876. 81	1, 754, 913. 10	1, 208, 713. 98	16, 670, 237. 86	7, 207, 707. 96	23, 877, 945. 82
1920	58, 056. 58	2, 657, 675. 44		174, 313. 68	2, 890, 045. 70	776, 198. 84	3, 666, 244. 54
	437, 790. 55	15, 984, 552. 25	1, 754, 913. 10	1, 383, 027. 66	19, 560, 283. 56	7, 983, 906. 80	27, 544, 190. 36
						Ore reserves	
		22, 964, 685. 91	2, 905, 368. 56		25, 870, 054. 47	4, 970, 649. 26	30, 840, 703. 73

55 PLAINTIFFS' EXHIBIT C

Re depletion

[Phelps Dodge Corporation, Combined]

	Treasury Department's valuations as of 1st Mar., 1913	Rate for depletion per lb. copper
Copper Queen:		
Limestone	$65, 369, 000. 00	0. 0411
Porphyry	15, 355, 000. 00	. 0229
Moctezuma	25, 260, 000. 00	. 0331
Burro Mountain	6, 269, 000. 00	. 0310
Morenci	8, 832, 000. 00	. 0264
Total copper properties	121, 085, 000. 00	
Stag Canon coal properties	11, 200, 000. 00	. 0521
	132, 285, 000. 00	

Re depletion—Continued

	Depletion	
	At department's rates	Per books
1913 (10 mos.)	$4, 747, 251. 87	$853, 649. 57
1914	4, 572, 808. 56	686, 834. 45
1915	4, 877, 786. 88	780, 835. 58
1916	5, 925, 161. 34	6, 578, 937. 95
1917	5, 714, 419. 26	5, 516, 526. 67
	25, 837, 427. 91	14, 416, 784. 22
1918	6, 196, 230. 63	5, 662, 813. 11
1919	3, 800, 225. 03	3, 798, 348. 49
	35, 833, 883. 57	23, 877, 945. 82
1920	3, 666, 244. 54	3, 666, 244. 54

56 PLAINTIFF'S EXHIBIT D

Phelps Dodge Corporation. Memorandum re changes in financial condition—1912–1917. [Omitted. Printed side page 32p, ante.]

57 PLAINTIFF'S EXHIBIT E

Phelps Dodge Corporation (Copper Queen, Burro Mountain, and Morenci Branches)—copper sales, 1917

	Deliveries of copper, in pounds	Gross amount received therefore, dollars
January	13, 272, 862	3, 507, 844. 47
February	18, 023, 748	4, 755, 572. 92
March	7, 282, 629	2, 009, 219. 65
April	18, 265, 849	4, 936, 031. 10
May	18, 003, 910	4, 959, 536. 73
June	14, 853, 376	4, 008, 460. 65
July	16, 031, 508	4, 425, 617. 10
August	14, 620, 334	4, 056, 514. 79
September	14, 247, 135	3, 929, 826. 67
October	13, 043, 543	3, 372, 929. 41
November	14, 381, 937	3, 586, 916. 04
December	10, 759, 259	2, 638, 576. 70
Total	172, 796, 090	46, 187, 046. 23

58 PLAINTIFF'S EXHIBIT F

Phelps Dodge Corporation—Condensed summary of combined costs of copper sold, year 1917

	Amount	Average per pound copper sold.
Mining, treating and refining charges	$21, 545, 456. 51	$0. 1247
Less silver and gold saving	2, 791, 725. 33	. 0162
	18, 753, 731. 18	. 1085
Add:		
Depreciation of plants, etc	1, 097, 431. 77	. 0064
General expenses	796, 633. 71	. 0046
Taxes	5, 857, 595. 21	. 0339
Depletion of mines	5, 516, 526. 67	. 0319
Total combined costs	32, 021, 918. 54	. 1853
Less:		
Profit on operations of coal and mercantile departments	1, 674, 525. 01	
Miscellaneous earnings	498, 899. 32	
	2, 173, 424. 33	. 0126
Cost of copper sold, year 1917	29, 848, 494. 21	. 1727

February 7, 1922.

59 PLAINTIFF'S EXHIBIT G

Phelps, Dodge & Co.—Balance sheet, December 31, 1916 (including assets and liabilities of subsidiary companies owned)

ASSETS

Fixed:			
Mines and mining claims, coal mines, etc	$34, 578, 682. 43		
Less reserve for depletion of ore and coal	8, 409, 548. 95	$26, 169, 133. 48	
Buildings and machinery at mines, reduction works, miscellaneous buildings, ranches, etc	14, 360, 059. 32		
Less reserve for depreciation	3, 904, 847. 87	10, 455, 211. 45	
Investments in sundry companies		2, 644, 214. 01	$39, 268, 558. 94
Deferred:			
Expenditures in suspense and paid in advance		560, 301. 62	
Materials and supplies for use in future operations		2, 202, 912. 10	2, 763, 213. 72

Current:		
Merchandise held for sale	$1,648,355.24	
Metals in process and on hand—copper at cost; silver and gold at market	7,993,924.24	
Accounts receivable	4,031,300.34	
Marketable securities	3,062,031.50	
Cash	7,746,519.71	
		$24,482,131.03
		66,513,903.69

LIABILITIES

Capital stock:		
Authorized issue—500,000 shares of $100.00 each, of which there have been issued 450,000 shares		$45,000,000.00
Current:		
Taxes accrued	$1,471,131.22	
Accounts payable	3,830,596.83	
Wages payable	525,049.22	
		5,826,777.27
Surplus:		
Balance December 31, 1915	8,337,863.75	
Earnings for year ending December 31, 1916 $24,030,904.69		
Less depletion of ore and depreciation on plants 2,056,642.02		
	21,974,262.67	
	30,312,126.42	
Deduct dividends paid	14,625,000.00	
		15,687,126.42
		66,513,903.69

60 PLAINTIFF'S EXHIBIT H

Extract from photostat of page 87 of ledger:

3	Surplus account	$2,250,000	
56	To dividend No. 2 and extra. For dividend payable this day as follows:		
	Regular, 450,000 shares @ $2½	1,125,000	
	Extra, 450,000 shares @ $2½	1,125,000	
			$2,250,000
58	Reserve for depletion	1,350,000	
	To distribution from reserve for depletion No. 1		1,350,000
	For amount distributed this day from reserve for depletion to stockholders as a return of capital invested; say, 450,000 shares © $3.00 per sh	1,350,000	

PLAINTIFF'S EXHIBIT I

Extract from photostat of page 123 of ledger:

58	Reserve for depletion	$2,250,000	
58	To distribution from reserve for depletion No. 2		2,250,000
	For amount distributed this day from reserve for depletion to stockholders as a return of capital invested: say, 450,000 shares @ $5.00 per share		

Photostat of page 58 of ledger:

DISTRIBUTION FROM RESERVE FOR DEPLETION #1

1917						1917			
Dec. 31.	125	To First N. Bk. Spec. a/c		1,347,750		Sept. 26.	87	By Res. for depletion	1,350,000
"		" balance		2,250					1,350,000
					1,350,200				
1918						1917			
June 28.	208	To First N. B. Spec. a/c 2/26		459		Dec. 31.		By balance	2,250
"	"	" Do.	6/25	1,041					
Nov. 30.	30	" Do.	9/27	447					
Dec. 31.	55	" Do.		3					
"		" balance		300					
					2,250				2,250
1919						1918			
Oct. 8.	155	To First N. Bk. Spec. a/c 3/25		300		Dec. 31.		By balance	300

DISTRIBUTION FROM RESERVE FOR DEPLETION #2

1918						1917			
June 28.	208	To First N. B. Spec. a/c 3/26		2,246,565		Dec. 28.	125	By res. for deplet.	2,250,000
"	"	" Do.	6/25	1,735					
Nov. 30.	30	" Do.	9/27	745					
Dec. 31.	55	" Do.		955					
					2,250,000				2,250,000

62

DISTRIBUTION FROM RESERVE FOR DEPLETION #3

1918						1918			
Nov. 30.	30	To First N. B. Spec. a/c 9/27		898,874		June 28.	208	By res. for deplet.	900,000
Dec. 31.	55	" Do.		106					
31.		" balance		1,020					
					900,000				900,000
1919						1918			
Oct. 8.	185	To First N. Bk. Spec. a/c 3/28		40		Dec. 31.		By balance	1,020
"	156	" Do.	6/30	500					
Dec. 31.	219	" Do.		380					
"		" balance		100					
					1,020				1,020
						1919			
						Dec. 31.		By ledger No. 2	100

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DISTRIBUTION FROM RESERVE FOR DEPLETION #4

1918						1918			
Sept. 30.	4	To U. S. of A. 10/25 y. C. 4¼% B.	891,300			Sept. 30.	4	By res. for deplet.	900,000	
Dec. 31.	55	To First N. Bk. Spec. a/c	8,558							
"		" balance	142							
				900,000						900,000
1919						1918			
Oct. 8.	185	To 1st N. Bk. Spec. a/c 3/28	112			Dec. 31.		By balance	142	
Dec. 31.	219	" Do.	30							
				142						142

DISTRIBUTION NO. 5 FROM RESERVE FOR DEPLETION

1919						1918			
Jan. 2.	93	To U. S. of Amer. 4¼ % bond	891,200			Dec. 31.	42	By res. for depletion	900,000	
Oct. 8.	185	To 1st N. Bk. Spec. a/c 3/28	8,678							
"	186	" Do 6/30	92							
Dec. 31.	219	" Do	30							
				900,000						900,000

RESERVE FOR DEPLETION

1917						1917			
Sept. 26.	84	To dist. from res. for D. #1	1,350,000			Dec. 31.		By balance	3,000,000	
Dec. 28.	120	" Do #2	2,250,000							
				3,600,000						3,600,000
1917						1918			
Dec. 31.		To balance	3,600,000			Dec. 31.		By balance	6,300,000	
1918										6,300,000
June 28.	208	" Dist. #3 from res. for D.	900,000							
Sept 30.	4	" " #4 " " " "	900,000							
Dec. 31.	42	" " #5 " " " "	900,000							
				6,300,000						
1918						1919			
Dec. 31.		To balance	6,300,000			Dec. 31.		By ledger #2	6,300,000	
1919										
Dec. 31.		To ledger #2	6,300,000							

PLAINTIFF'S EXHIBIT K

Photostat of page 9 of ledger:

DEPLETION RESERVE

		Copper Queen					
1919 Dec. 31.	To balance	13,326,876.81		1917 April 2.	8 By sundries	4,882,550.09	
				Dec. 31.	24 " mine deple.	3,065,500.20	
				1918 Dec. 31.	82 " " "	3,005,610.30	
				1919 Dec. 31.	244 " " "	2,373,216.22	
		13,326,876.81					13,326,876.81
				Dec. 31.	By ledger #2	13,326,876.81	
		Morenci					
1919 Dec. 31.	To balance	1,754,913.10		1917 April 2.	10 By sundries	815,851.83	
				Dec. 31.	24 " mine deple.	166,758.12	
				1918 Dec. 31.	82 " " "	417,979.32	
				1919 Dec. 31.	244 " " "	354,323.83	
		1,754,913.10					1,754,913.10
				1920 Dec. 31.	By ledger #2	1,754,913.10	
		Burro Mountain					
1919 Dec. 31.	To balance	1,208,713.98		1917 April 2.	11 By sundries	227,911.11	
				Dec. 31.	24 " mine deple.	248,163.89	
				1918 Dec. 31.	82 " " "	582,981	
				1919 Dec. 31.	244 " " "	149,657.98	
		1,208,713.98					1,208,713.98
				1919 Dec. 31.	By ledger #2	1,208,713.98	

65

Plaintiff's Exhibit L

Photostat of page 10 of ledger:

ORE RESERVE

1919 Dec. 31.	To balance	Copper Queen	22,964,685.91		1917 Apr. 2.	8	By sundries	22,964,685.91	
					1918 Dec. 31.		By ledger #2	22,964,685.91	
1919 Dec. 31.	To balance	Morenci	2,905,368.56		1917 Apr. 2.	10	By sundries	2,905,368.56	
					1919 Dec. 31.		By ledger #2	2,905,368.56	

66

Plaintiff's Exhibit M

Photostat of page 14 of ledger:

DEPLETION RESERVE. STAG CANON

1919 Dec. 31.	To balance	For Dawson Fuel Co. properties	346,748.68	346,748.68	1917 April 2.	12	By sundries	195,206.08	
					Dec. 31.	24	" mine deple.	47,370.23	
					1918 Dec. 31.	68	" daw. off.	62,220.37	
					1919 Dec. 31.	241	" " "	41,952	346,748.68
					1919 Dec. 31.		By ledger #2	346,748.68	
1919 Dec. 31.	To balance	For Stag Canon properties	32,985.29		1917 April 2.	12	By sundries	21,885.85	
					Dec. 31.	24	" Mine deple.	3,812.08	
					1918 Dec. 31.	68	" daw. off.	4,560.12	
				32,985.29	1919 Dec. 31.	241	" " "	2,727.24	32,985.29
					1919 Dec. 31.		By ledger #2	32,985.29	

Photostat of page 3 of ledger:

SURPLUS

1917					1917		
June 28.	80	To div. #1 & extra	3,600,000		April 2.	8	By Copper Queen	93,460,853.85	
Sept. 26.	87	" div. #2 & extra	2,250,000		" 2.	10	" Morenci	641,745.82	
Dec. 28.	124	" div. #3 & extra	2,250,000		" 2.	11	" Burro Mt.	251,199.84	
" 31.		" balance	118,155,155.67		" 2.	13	" Stag Canon	22,182.61	
				126,255,155.67	" 2.	14	" certif. of indebt.	31,450,000	
					" 13.	"	" P. D. Co.	429,173.55	
									126,255,155.67
1918					1917				
Mar. 29.	168	To div. #4 & extra	3,600,000		Dec. 31.		By balance	118,155,155.67	
June 28.	207	" " #5 & "	1,800,000		" 31.		" Gen. P. & L.	14,588,711.61	
Sept. 30.	4	" " #6 &	2,700,000		1918				
Dec. 31.	42	" " #7 & "	2,700,000		Dec. 31.	86	" Do.	10,101,616.66	
" 31.		" " balance	132,045,483.94						
				142,845,483.94					142,845,483.94
1919					1918				
Mar. 31.	112	To div. # 8	1,125,000		Dec. 31.		By balance	132,045,483.94	
June 30.	153	" " # 9	1,125,000						
Sept. 30.	182	" " #10	1,125,000		1919				
Dec. 31.	219	" " #11	1,125,000		Dec. 31.	252	" Gen. P. & L.	2,416,751.80	
"		" balance	129,962,235.74						
				134,462,235.74					134,462,235.74
					1919				
					Dec. 31.		By ledger #2	129,962,235.74	

Photostat of page 4 of ledger:

GENERAL PROFIT & LOSS

1917					
Dec. 31.	149	To exps. pro. committee		600. 25	
"	15	" charges		91, 185. 60	
"	21	" exps. plant		262, 258. 96	
"	22	" tailings exps.		14, 017. 12	
"	"	" sundries		30, 000. 09	
"	27	" mine depl. C. Q.		3, 065, 500. 20	
"	"	" " " Morenci		166, 758. 12	
"	"	" " " Burro Mt.		248, 163. 89	
"	"	" " " D. F. Prop.		47, 370. 23	
"	"	" " " Stag "		3, 812. 08	
"	"	" plant depr. C. Q.		315, 421. 03	
"	"	" " " Morenci		29, 143. 93	
"	"	" " " Burro Mt.		151, 156. 08	
"	"	" " " D. F. Prop.		34, 889. 19	
"	"	" " " Stag "		21, 894. 35	
"	"	" taxes		263, 721. 85	
"	"	" income tax accruals		2, 756, 647. 30	
"	28	" surplus		14, 588, 711. 61	
					22, 091, 252. 48
1918					
Dec. 31.	75	To charges		128, 397. 30	
"	"	" laboratory exp.		616. 25	
"	76	" U. S. 15/30 yr. 3½% bond		9, 690. 65	
"	"	" U. S. 10/25 yr. 4¼% bond		12, 150	
"	78	" sundries		4, 470. 86	
"	"	" priv. car, "Alamagordo"		2, 129. 43	
"	80	" sundries		2. 32	
"	82	" organ. mt. prosp.		345, 865. 53	
	82	" taxes		114, 807. 47	

1917					
Dec. 31.	135	By Caski.		4	
"	"	" London office		4. 77	
"	22	" sundries		3, 300, 219. 26	
"	147	" voucher		952. 08	
"	23	" inv. in sund. Co.'s		1, 687. 70	
"	28	" C. Q. profit & loss		16, 859, 103. 77	
"	"	" Morenci "		526, 363. 34	
"	"	" Burro Mt. "		709, 755. 71	
"	"	" Stag Canon "		633, 161. 85	
					22, 091, 252. 48
1918					
Dec. 31.	76	By Anglo Fr. Bonds		29, 045	
"	"	" U. K. Gt. B. & Ire. "		13, 461. 87	
"	"	" Daw. Ry. & C. Co. "		172. 50	
"	78	" tailings exp.		432. 99	
"	84	" div. from subs. Co's.		2, 470, 000	
"	"	" div. from sund. inv.		259, 124. 11	
"	"	" comm. earned		343, 098. 35	
"	"	" discts. R. & A.		1, 707. 87	
"	"	" interest		503, 527. 58	
"	85	" C. Q. P. &L.		11, 983, 941. 89	

GENERAL PROFIT & LOSS—Continued

Dec. 31.	84	To charities & D.			535,375
"	"	" charges			47,286.80
"	85	" mine deple. C. Q.			3,006,610.30
"	"	" " " Mor.			417,979.32
"	"	" " " B. Mt.			592,981
"	"	" " " D. F. Prop.			62,220.37
"	"	" " " Stag			4,560.12
"	"	" plant depre. C. Q.			363,071.42
"	"	" " " Mor.			51,872.75
"	"	" " " B. Mt.			217,440.81
"	"	" " " D. F. Prop.			46,518.92
"	"	" " " S. C. Br.			38,428.16
"	86	" inc. tax accruals			2,707,328.11
"	"	" surplus			10,101,616.66
					18,800,519.55
1919					
Dec. 31.	206	To pur. dept. exp.			15.40
"	207	" charges			146,340.63
"	"	" organ. mt. pros.			3,371.62
"	223	" inv. sundry Co s.			13.42
"	233	" plant & eq. C. Q.			6,270.82
"	245	" Stag C. pay			.01
"	249	" sundries			97,760.60
"	"	" mine depletion			2,921,877.27
"	250	" sundries			294,530.14
"	"	" C. Queen plant dep.			363,239.98
"	"	" Mor. " "			51,483.40
"	"	" Burro Mt. " "			215,450.56
"	"	" daw. F. prop. "			155,063.06
"	"	" stag C. " "			89,108.97
"	"	" in rails & fort prior to 1918			29,800
"	"	" in rails & fort for 1918			17,599.95
"	251	" sundries			292,614.58
"	252	" Do			8,789,601.44
"	"	" inc. tax accruals			273,585.72
"	"	" surplus			2,16,751.80
					16,163,512.37

Dec. 31.	85	By mor.	"	"	958,203.01
"	"	" B. Mt.	"	"	1,116,194.71
"	"	" Stag	"	"	1,112,802.69
"	"	" Cope. B.	"	"	8,676.98
					18,801,519.55
1919					
Dec. 31.	228	By Daw. R. & C. Co. Bank			5,235
"	249	" Sundries			3,000,722.97
"	250	" "			1,112,898.04
"	251	" gen. P. & L.			155,063.06
"	"	" " "			89,108.97
"	"	" " "			29,800
"	"	" " "			17,599.95
"	"	" sundries			7,788.49
"	252	" "			11,214,967.03
"	"	" inc. tax accru.			531,328.86
					16,163,512.37

Photostat of page 32 of ledger:

RESERVE FOR DEPLETION (DEPLETION RESERVED)

1917				Sept. 30, 1917		
Sept. 27.	To N. Y. voucher dfts.	R. 85	520,000.00	as		
Dec. 27.	" do	" 94	520,000.00	Dec. 31, 1916. By mine depreciation reserve	J. 43	3,127,944.74
31.	" profit & loss	J. 50	2,585,585.50	1917		
	balance		3,701,774.74	Dec. 31. By mine depreciation	" 48	2,985,585.50
				31. " profit & loss	" 50	1,613,880.00
			7,727,360.24			7,727,360.24
1918				1917		
Mar. 26.	To P. D. Corpn.	R. 102	260,000.00	Dec. 31. By balance		3,701,774.74
June 27.	" do	" 110	260,000.00	1918		
Sept. 26.	" do	" 119	260,000.00	Dec. 31. " mine depletion	J. 56	1,589,462.00
Dec. 31.	" do	" 128	520,000.00			
31.	balance		3,991,236.74			
			5,291,236.74			5,291,236.74
1919				1918		
Dec. 31.	To profit & loss	J. 65	932,578.00	Dec. 31. By balance		3,991,236.74
"	balance		4,867,707.96	1919		
				Dec. 31. " mine depletion	J. 63	932,578.00
				31. " profit & loss	" 65	876,471.22
			5,800,285.96			5,800,285.96
				1919		
				Dec. 31. By balance		4,867,707.96
				1920		
				Dec. 31. " mine depletion	J. 71	776,198.84

71 PLAINTIFF'S EXHIBIT Q

Extract of photostat of page — of ledger:

ORE RESERVE

Sept. 30, 1917, as Dec. 31, 1916. By surplus		J. 43	4,970,649.26

PLAINTIFF'S EXHIBIT R

ANNUAL REPORT PHELPS DODGE CORPORATION, 1917

NEW YORK, *February 28, 1918.*

To the stockholders of Phelps Dodge Corporation:

GENTLEMEN: In a letter to the stockholders under date of March the 31st, 1917, the plan of reorganization was outlined to you whereby the name of the Copper Queen Consolidated Mining Company was changed to Phelps Dodge Corporation and its capital stock increased. At the same time the properties of the Detroit Copper Mining Company of Arizona, Burro Mountain Copper Company, and Stag Canon Fuel Company, and also the stocks of the Moctezuma Copper Company, Bunker Hill Mines Company, and
72 Phelps Dodge Mercantile Company were transferred to Phelps Dodge Corporation. Later, in continuance of this plan, at a meeting of the stockholders of Phelps, Dodge & Company, held on May the 15th, 1917, the stockholders voted and consented to the dissolution of Phelps, Dodge & Company. The former subsidiaries of Phelps, Dodge & Company are now designated as Copper Queen branch, Morenci branch, Burro Mountain branch, and Stag Canon branch of Phelps Dodge Corporation.

During the early part of the year the market price of copper reached a record figure, which acted as an incentive to push production to the maximum. The output for the first six months from your properties reached the large figure of 80,497,835 pounds. In June and July, labor troubles, fomented at Bisbee by the I. W. W. and at Morenci by the local Mexican union, served in the case of the Copper Queen branch to seriously affect the ore production and in the case of the Morenci branch to cause complete suspension of operations for a period of four months. In September the United States Government fixed an arbitrary market price for copper at 23½ cents per pound, which obtained through the balance of the year. Owing to the greatly increased production costs, due to the high cost of labor and supplies, and the seriously decreased efficiency of labor, this price caused a certain reduction of output because of the inability to work profitably low grade ore which previously had allowed a small margin of profit.

The metal produced from the ores of the branches and sub-
73 sidiaries of the Phelps Dodge Corporation was 153,974,692 pounds of copper, 8, 136,356 pounds of lead, 1,524,632 ounces

purchased or smelted on toll at the reduction works, ores yielding 51,907,525 pounds of copper, 946,921 ounces of silver, and 10,957 ounces of gold.

Including copper received from other sources, 290,522,569 pounds were sold and delivered to buyers at a price of 26.67 cents per pound, net cash f. o. b. New York.

	Pounds
To domestic trade	185,131,891
To foreign trade	105,390,678
The company sold:	
Of their own mine product	156,114,518
Of copper from ores purchased	16,681,572
Of copper on commission	117,726,479
The above consisted of:	
C. * Q. electrolytic copper	274,449,140
P. D. ingot copper	15,528,429

Throughout the year the demand for copper greatly exceeded the supply and the fluctuations in the price between the maximum of 33¾ cents per pound in the early part of the year and 23½ cents during the last third are indicative of the market conditions and the uncertainty of the trade. Through the fixed principle pursued by the selling agency of your company the average price obtained for the copper output of your companies exceeded that received in 1916 by 2.19 cents per pound, although the quotational average as published by the Engineering and Mining Journal was slightly lower than the previous year.

The copper production derived from the mines of the Cop-
74 per Queen Branch, after reaching record production the first six months, showed a marked decrease in the latter half of the year, the yield being 87,831,317 pounds of copper, as compared with 95,397,219 pounds for 1916. This result was largely due to the labor troubles and the loss of skilled miners through the operations of the selective draft. A large increase in the holdings of mineral ground in the Warren district has been acquired by the Copper Queen branch through the purchase of the mining claims of the Warren Realty & Development Company and the Rough Rider Group, aggregating about 2,074 acres.

At the Morenci branch the strike completely stopped the production of copper for four months and caused a very much reduced output for November and December. It is probable that the normal production of this property will not be reached until after the first half of the current year, owing to the operating difficulties in obtaining normal production after a prolonged shut-down.

The Moctezuma Copper Company, operating in Sonora, Mexico, was enabled, through more satisfactory political conditions in that State, to reach its highest output on record, and while the cost of producing copper from this property has greatly increased on account of the heavy Mexican State and Federal taxes and the higher prices paid for supplies and labor, the financial outcome of the year's operations may be regarded as satisfactory.

The Burro Mountain branch produced 13,139,053 pounds of copper as against 6,980,885 pounds during the previous year, and experienced no difficulties with its labor. Because of the
75 satisfactory development of this company's ore reserves during the past three years, the mill capacity will be still further increased and a larger production attained.

At the Stag Canon branch, the mines and ovens operated continuously throughout the year and both the output and the financial result of the operations were extremely satisfactory.

At the mines of the Bunker Hill Mines Company, operations during the past year have not opened up any new ore bodies of value, notwithstanding the active development work that was done above water level.

At Organ, New Mexico, prospecting operations were continued under disadvantageous circumstances. No ore of importance has been developed to date on the upper levels and the work on the lower levels now under way should demonstrate in the near future whether the property has any value to us.

In August the Phelps Dodge Corporation purchased from the Commercial Mining Company all of its real and personal property, including its mines in Yavapai and Mohave Counties in Arizona. These properties, while of minor importance at the present time, are profitable and may develop into more important producers in the future.

While the general labor shortage throughout the West made it impossible to carry out the normal amount of development work looking to the exploration of new ore bearing areas, it is satisfactory to be able to report that, without exception, the known ore reserves have been materially increased in all of your mines.

76 Dr. James Douglas, who for many years has been president of your company, tendered his resignation as president on account of ill health, and in the words of the following resolution, was appointed chairman of the board of directors:

"Whereas, after thirty-five years of activity in the development of the properties of this company and its subsidiaries, whose success is largely due to his rare skill and untiring efforts, President Douglas has intimated his desire to be relieved of the burdens of administrative detail, and has presented his resignation as president of this company; and

"Whereas, the board of directors, desirous of doing what will be most helpful to Dr. Douglas, nevertheless feel, that after all these years of cordial cooperation they cannot permit him to entirely sever his official relations with the company; and desire to retain him in a position where, without being burdened with matters of detail, he may still give the company the benefit of his long experience, by wise counsel and advice:

"Be it therefore, resolved, that the resignation of Dr. James Douglas as president of this company is accepted with regret and that he is hereby appointed chairman of the board of directors, and

is authorized and empowered to manage the affairs and business of the company and to bind the company by his acts and signature with the same effect as though he were president of the company."

77 Mr. Walter Douglas was elected president. Mr. S. W. French, formerly general manager, has resigned, and Mr. A. T. Thomson, assistant to the president, has been transferred to Douglas, Arizona. Mr. P. G. Beckett, formerly general manager of the Old Dominion Company, has been appointed assistant to the president, with headquarters in New York.

Four dividends of 2½% each and extra dividends of 3½% in March, 5½% in June, 2½% in September, and 2½% in December, amounting to 24%, exclusive of 8% distributed from the "Reserve for depletion," or 32% in all, were paid during 1917. Of these dividends, as pointed out in a statement to stockholders under date of January 29, 1918, the dividend paid in March, 1917, was paid by Phelps, Dodge & Company and was declared and paid entirely out of the profits accrued during the year 1916. The other three regular dividends and extras were paid by Phelps Dodge Corporation out of earnings for the year 1917, and the special dividends of September and December were a "distribution from the reserve for depletion."

WALTER DOUGLAS,
President.

78 *Phelps Dodge Corporation balance sheet, 31st December, 1917 (including assets and liabilities of subsidiary companies owned)*

ASSETS

Fixed:		
Mines and mining claims	$179,630,650.83	
Buildings, plants, and miscellaneous properties	15,774,741.60	
Investments in sundry companies	3,129,481.03	
		$198,534,873.46
Current:		
Materials and supplies and expenses prepaid	3,439,360.32	
Merchandise held for sale	2,123,820.34	
Metals on hand—copper at cost, silver and gold at market	8,613,871.88	
Accounts receivable	5,880,185.60	
Cash and marketable securities	13,775,627.84	
		33,832,865.98
		232,367,739.44

LIABILITIES

Capital stock:		
Authorized—500,000 shares, of $100.00 each.		
Issued—450,000 shares		$45,000,000.00
Current:		
Accounts and wages payable and taxes accrued		9,523,198.19
Reserves:		
For depletion—after deducting $3,600,000.00 distributed to stockholders in 1917	$41,657,487.95	
For depreciation	4,290,206.42	
		45,947,694.37
Surplus—per surplus account attached		131,896,846.88
		232,367,739.44

79 *Phelps Dodge Corporation profit and loss account (including operations of subsidiary companies owned), year ending 31st December, 1917*

Income:		
Sales of copper, lead, silver, and gold	$48, 978, 771. 56	
Sales of coal, coke, and merchandise	12, 182, 687. 21	
Income from investments and miscellaneous earnings	1, 100, 726. 95	
		$62, 262, 185. 72
Expenses:		
Mining, treating and refining metals	21, 545, 456. 51	
Cost of coal, coke, and merchandise sold	10, 508, 162. 20	
Depreciation of buildings and plants	1, 097, 431. 77	
General and administrative expense	796, 633. 71	
State and governmental taxes	5, 857, 595. 21	
		39, 805, 279. 40
Profits for the year 1917—carried to surplus account		22, 456, 906. 32

SURPLUS ACCOUNT

Balance 31st December, 1916	15, 687, 126. 42
Increase in valuation of mines to comply with Government regulations	110, 069, 340. 81
Profit for the year 1917—profit and loss account	22, 456, 906. 32
	148, 213, 373. 55
Provision for depletion of mines—year 1917	5, 516, 526. 67
	142, 696, 846. 88
Dividends paid	10, 800, 000. 00
Balance 31st December, 1917—carried to balance sheet	131, 896, 846. 88

On account of the shortage of labor, the production of lead ores was sacrificed to the effort to mine all copper ore possible, resulting in a decreased tonnage of this material as compared with the previous year.

80 PRODUCTION OF REDUCTION WORKS

The number of tons of ore charged and the ounces of gold and silver and pounds of copper produced at the reduction works follow:

	Dry tons charged	Ounces gold	Ounces silver	Pounds copper
Copper Queen Branch	794, 904	19, 171	550, 156	87, 831, 317
Burro Mt. Branch	45, 868	293	36, 799	13, 342, 508
Moctezuma Copper Co	167, 381	1, 910	508, 387	38, 499, 781
All other	268, 664	10, 957	946, 921	51, 907, 525
Total 1917	1, 276, 817	32, 331	2, 042, 263	19', 581, 131
Total 1916	1, 304, 523	32, 832	1, 794, 854	17', 893, 880

PLAINTIFFS' EXHIBIT S

Consolidated return as required by regulations 41, art. 78 and Treasury Decision 2662.

CORPORATION EXCESS PROFITS TAX RETURN

Taxable year ended 31st December, 1917. Name, Phelps Dodge Corporation. Business address, 99 John Street, New York. Kind of business, general mining & mercantile business. Date established, Dec. 14, 1908.

SCHEDULE I.—*Net income for taxable year subject to excess profits tax*

1. Net income for taxable year shown in item 8, Form 1031, for this and all affiliated companies per statement "F" attached		$22, 970, 791. 62
		22, 970, 791. 62
4. Less (a) dividends received as shown in item 3d, Form 103, per statement "F" attached	$2, 699, 351. 71	
(b) Interest paid		2, 699, 351. 71
Net income subject to excess profits tax		20, 271, 439. 91

81

SCHEDULE II.—*Invested capital*

Item	1911	1912	1913	Taxable year
1. Capital, surplus, and undivided profits at the close of the preceding year as shown by corporation's books before making any adjustments therein	$44, 671, 873. 61	$45, 712, 274. 75	$51, 129, 679. 67	$55, 809, 708. 81
2. Adjustments by way of additions	45, 000, 000. 00	45, 000, 000. 00	45, 000, 000. 00	49, 532, 146. 78
3. Total	89, 671, 873. 61	90, 712, 274. 75	96, 129, 679. 67	105, 341, 855. 59
4. Adjustments by way of deductions				
5. Invested capital at beginning of year	89, 671, 873. 61	90, 712, 274. 75	96, 129, 679. 67	105, 341, 855. 59
6. Changes in invested capital during year				
7. Invested capital for year	89, 671, 873. 61	90, 712, 274. 75	96, 129, 679. 67	105, 341, 855. 59
8. Total invested capital for pre-war period				276, 513, 828. 03

SCHEDULE III.—*Deduction*

1. Percentage—net income to invested capital for pre-war period	10. 5%
2. Percentage to be used in computing deduction	9. %
3. Amount of deduction computed at above rate on invested capital for taxable year	$9, 480, 767. 00
4. Exemptions (except for foreign corporations)	3, 000. 00
Total Deduction	9, 483, 767. 00

82 SCHEDULE IV.—*Computation of Tax*

Classes of income for computation of tax.—Over $0.00, but not over 15% of invested capital; amount of income in this class, $15,801,278.34; deduction, $9,483,767.00; balance subject to tax, $6,317,511.34; rate, 20%; amount of tax, $1,263,502.27.

Classes of income for computation of tax.—Over 15% of invested capital; but not over 20% of invested capital; amount of income in this class, $4,470,161.57; balance subject to tax, $4,470,161.57; rate, 25%; amount of tax, $1,117,540.39.

SUMMARY

Total: Amount of income in each class, $20,271,439.91; deduction, $9,483,767.00; balance subject to tax, $10,787,672.91; total amount of tax, $2,381,042.66.

83 SCHEDULE A.—*Capital, surplus, and undivided profits as shown by books before making any adjustments therein*

Item	1911	1912	1913	Taxable year
Capital stock paid up and actually outstanding at the close of the preceding year:				
3. Common	$45,000,000.00	$45,000,000.00	$45,000,000.00	$45,000,000.00
Total	45,000,000.00	45,000,000.00	45,000,000.00	45,000,000.00
6. Earned surplus	328,126.39	712,274.75	6,129,679.67	10,809,708.81
8. Grand total	44,671,873.61	45,712,274.75	51,129,679.67	55,809,708.81

SCHEDULE B.—*Adjustments by way of additions*

Item	1911	1912	1913	Taxable year
2. Value of tangible property in excess of par value of stock issued therefor as of date of issue see supplementary statement attached marked "A"	$45,000,000.00	$45,000,000.00	$45,000,000.00	$45,000,000.00
4. Depreciation charged in accounts of corporation but disallowed by Treasury Department as expense on income tax return				4,532,146.78
Total	45,000,000.00	45,000,000.00	45,000,000.00	49,532,146.78

SCHEDULE F.—*Net income during pre-war period*

Item	1911	1912	1913
3. Total for each year	$8,440,401.14	$12,167,404.92	$10,446,173.65
5. Net total for year 1913			10,446,173.65
6. Grand total for pre-war period			21,053,979.71

84 QUESTIONS

1. Explain the nature of the corporation's business if not adequately described on first page:

(a) Main business mining and treating copper ores and selling metal.

(b) Collateral businesses, if any coal mining and general mercantile business.

2. Date of incorporation. See statement "A" attached.

3. Under the laws of what State or country?

4. Enter on the following lines the names and addresses of three representative concerns in your locality engaged in the same kind of business. See statement "A" attached.

5. What was the fair value of the total capital stock of the corporation as determined in the last assessment of the capital stock tax (if any)? Specify the year $135,000,000.00 in 1917.

6. If any patent is included among your assets attach a schedule to this return showing for each patent its serial number, date of issue, name of patentee, amount of cash or stock paid therefor, and its present book value. None.

85 STATEMENT BY PHELPS CORPORATION, ANNEXED TO 1917 EXCESS PROFITS TAX RETURN

This corporation was formerly organized as of March 1, 1917, and is a continuation of the business of Phelps, Dodge & Co., Inc. The latter company was the incorporation in December, 1908 of the long established partnership of Phelps, Dodge & Company, which had owned and operated valuable mines in the southwest for a number of years prior to that time. Phelps Dodge Corporation owns the physical properties of all the companies taken over by Phelps, Dodge & Co., Inc., at the time of its organization, except those of the Moctezuma Copper Company, which by reason of their location in Mexico are retained in a separate corporation. In addition, it owns the capital stock of Phelps, Dodge Mercantile Company, and the mines of the Burro Mountain Copper Co., both acquired by Phelps, Dodge & Co., Inc., since the year 1908. In substance, in form, in manner of organization, in par value of capital stock ($45,000,000.00), and in tangible property owned Phelps Dodge Corporation is the same as Phelps, Dodge & Co., Inc., and should be so regarded.

With regard to invested capital, the company submits the following statement:

The par value of its capital stock is $45,000,000. This was valued by the Government in the year 1917, for the purpose of the capital stock tax, as $300 a share, giving a value of $135,000,000 fixed by the Government for the purpose of taxing it. This valuation was not

disputed by the company. The dividends of the company for
86 the year 1917 were $32 per share, or $14,400,000 which on a 10% basis would give a value of $144,000,000. The company's principal properties are as follows:

The Copper Queen mines at Bisbee, Arizona.
The Detroit Copper mines at Morenci, Arizona.
The Burro Mountain mines at Tyrone, New Mexico.
The Stag Canon mines at Dawson, New Mexico.
The Moctezuma mines at Nacozari, Mexico.
The Phelps Dodge Mercantile Co. stores.
The smelter at Douglas, Arizona.

However, the company is advised that by reason of the technical restrictions of section 207 of the war excess profits tax law, it will be unable to use its real invested capital for the year 1917 and at the same time comply with said restrictions. It is advised that the intent of section 207 is to prevent the taxpayer using his real invested capital for the taxable year, and to compel him to compute the same according to certain artificial rules and definitions therein contained. The chief of these is that when tangible property was paid in prior to January 1, 1914, for stock or shares of the corporation the invested capital must be taken as the value of such assets, not as of the taxable year, and to compel him to compute the same according to certain artificial rules and definitions therein contained. The chief of these is that when tangible property was paid in prior to January 1, 1914, for stock or shares of the corporation, the invested capital must be taken as the value of such assets,
not as of the taxable year, but as of January 1, 1914, and
87 even then in no case to exceed the par value of the original stock or shares specifically issued therefor.

Although the real invested capital of the company on January 1, 1914, was at least $135,000,000 the company is advised that the above restriction of the par value of the capital stock if valid, prevents its using its invested capital as of that date, provided, however, that the difference between the par value of the capital stock and the then value of the assets for which the stock was issued, can be treated as "paid-in surplus." The company is advised that the above provision that the value of the assets on January 1, 1914, shall not exceed the par value of the capital stock is an artificial and improper method of classification, and is invalid. It is advised that such a limitation will result in inequality of taxation as between companies with the same real assets as the par value of the capital stock is in no sense an index of real value. That it will discriminate against companies conservatively capitalized and that it will discriminate particularly against mining companies in that it seeks to prevent their using as a part of their capital, new ore bodies uncovered by the expenditure of large sums for development work.

The company, therefore, submits this statement and the annexed return, computing its invested capital in accordance with section

207 of the war excess profits tax law, and article 63 of "Regulations No. 41, relative to the war excess profits tax," under pro-
88 test and without prejudice or waiver of its right to contend later if it is so advised, that the methods of computing invested capital set forth in section 207 of said law, particularly the provision thereof limiting it to the value of its assets as of January 1, 1914, and not as of the taxable year, and even as to that date limiting said value to the par value of the capital stock, are invalid and void.

As of November 1, 1908, the smelters, mills, metal on hand at cost, and other assets of the companies then taken over by Phelps Dodge & Co., Inc., exclusive of the mines were valued at $28,949,739.53 with liabilities of $4,161,166.06 leaving a net value of assets, exclusive of mines of $24,788,573.47. This was unquestionably considerably below the real value of these assets as the policy of the company was to value its assets very conservatively. For instance, if copper on hand had been valued at the market and not at cost, it would have increased these values several million dollars.

As to the value of the mines taken over, any mining expert would advise that the mines were worth at least three or four times the value of the above plant and quick assets. From what was known of the mines in November, 1908, a value of from $75,000,000 to $125,000,000 would be conservative. So that the value of the mines, plant and quick assets for which the $45,000,000 stock was issued was from $100,000,000 to $150,000,000. The par capital stock was fixed at a comparatively small figure, because the stock was closely held. It was not intended to create a wide market for it, and it was deemed wise to err on the side of conservatism. While stock
89 capital of $90,000,000 to $150,000,000 was discussed and favorably considered at the time $45,000,000 was adopted as an amount on which the company could pay satisfactory dividends, even under the most adverse conditions, which could be imagined.

The market value of the stock in December, 1908, throws no light upon the subject, for the reason that the properties had always been private. There was no stock then upon the market. There were no transactions and no stocks for sale. In the year 1909 there were a few transactions, for the directors had issued $1,000,000 of stock to the employees at par, and some of this stock coming upon the market gave market sales valuations as follows:

On February,	1909	$175
May 28,	"	200
June	"	200
July 19,	"	225
July 22,	"	235
Dec. 29,	"	252

Considering the real value of the mines taken over (the Copper Queen, Detroit, Moctezuma, and Stag Canon) it is fair to give them a value of from $90,000,000 to $100,000,000. The earnings of the four properties taken over for three years last passed had averaged

about $7,400,000 per annum and that with only one company (the Copper Queen) in any way approaching its normal capacity. As to that company the valuation of its properties was corroborated, not only by its own explorations, but by those of the Calumet & Arizona Mining Co., whose properties are adjacent to those of
90 the Copper Queen, in Bisbee, Arizona, and are of much the same character. Both of these explorations indicated the continuance of a very large territory of high grade copper ore. The Copper Queen was widely known as one of the most valuable and extensive copper properties in the Southwest. Its mines were very extensive in area and were known to lie in one of the richest copper districts in the country. The properties owned by the Moctezuma Copper Co. and the Detroit Copper Co. were extensive, and the values ran throughout the territory. The earnings of neither one of these companies for the three years prior to the organization of Phelps, Dodge & Co., Inc., represented in any way the known earning capacity. For instance, the Moctezuma Copper Co. had just practically finished its development period. It had been producing an average of 10,000,000 to 11,000,000 pounds of copper per year, and that with a mill whose capacity was only 600 tons a day. This mill had just been abandoned and a new mill with a capacity of 2,000 tons a day put into operation, so that in the month of October, 1908, the company had produced 2,300,000 pounds of copper. It is therefore fair to assume that the earnings of that company should be based on practically 30,000,000 pounds of copper per year and would be at least three times the earnings shown during the development period. The company owned the town of Nacozari, in Mexico, with a library, hospital, hotel, boarding house, schools, workmen's houses, etc. The Detroit Copper Co. also had not been operating up to its normal capacity, as it had been producing an average
91 of only about 17,000,000 pounds of copper per year, whereas in the year 1908 improved facilities for treatment had increased the normal capacity of 2,000,000 pounds a month. The mines of the Stag Canon Fuel Co. were of great value. Among the other properties owned by this company were 36,000 acres of land underlaid by coal, and the company had the right to mine coal from an additional 17,500 acres. From a survey made at the time, it was estimated that from one of these beds, making the usual allowance for loss, over 200,000,000 tons of coal could be extracted. Just before the taking over of these properties they were equipped for a total capacity of 120,000 tons of coal a month, whereas in January, 1908, only 65,000 tons had been mined, and in February, 1908, only 41,688 tons. The company also owned coke ovens with a capacity of 27,000 tons a month. The total net earnings of the company during the fiscal year ending June 30, 1908, which was a year of deep industrial depression, and with only a part of the coke ovens in operation, amounted to $283,942.

In addition to the above plant, quick assets, and mines, the old firm of Phelps, Dodge & Co., also transferred to the new company its valuable metal selling business, and good will, which were not taken into account at all, in the stock issue.

From the above statement it seems clear that the opinion of the men who were acquainted with the value of these properties when they were acquired, to the effect that some $90,000,000 to $100,000,000 was a conservative value in 1908, is amply justified by the facts known at the time. The subsequent earnings of the com-
92 pany and the proven ore on hand to-day indicate that this judgment was conservative. In view of the fact that the Moctezuma mines are still held by a separate corporation and irrespective of their value in December, 1908, the company has decided to take the lower figure for the purpose of this tax and to fix a paid in surplus of $45,000,000 in accordance therewith.

From the date of its organization down to December 31, 1916, the campany's net profits were $75,642,213.09, of which it has paid out in dividends $60,300,357.50, leaving an earned surplus, 1909 to 1916, inclusive, of $15,341,855.59.

The invested capital of the company, therefore, even as limited by the technical limitations of the war excess profits tax law was, on December 31, 1916, as follows:

Capital stock	$45,000,000.00
Paid in surplus	45,000,000.00
Earned surplus	15,341,855.59
Total	105,341,855.59

If the above invested capital be disallowed by reason of any technical restriction not known to the company, it will be obliged to ask the Commissioner of Internal Revenue to fix the value of its invested capital in accordance with section 210 of the war excess profits tax laws, and article 52 of the above regulations, subdivisions (1), (3), and (4).

Dated, April 1, 1918.

PHELPS DODGE CORPORATION,
By (Signed) WALTER DOUGLAS, *President.*

93 CORPORATION INCOME TAX RETURN

Return of annual net income for the calendar year 1917 (Dec. 31, 1917):

Name of corporation, Phelps Dodge Corporation. Principal office, 99 John Street. Kind of business carried on, general mining business. Date of organization, Dec. 14, 1908.

1. (a) Paid-up "common stock"	$45,000,000
Total paid-up stock	45,000,000

INCOME

3. (a) Gross sales and other income from operations		$39,364,830.43
(c) Income from interest		326,485.62
(d) Income from dividends		2,699,251.71
(e) Income from all other sources		336,169.63
Total gross sales and other income		42,726,737.39
Less total deductions		25,348,750.77
8. Total net income		17,377,986.62
Less: (a) Excess profits tax (item 12)	$1,842,672.59	
(b) Dividends received out of earnings of 1913, 1914, 1915		
Total (a plus b)		1,842,672.59
94 9. (a) Amount taxable at 2% (item 8 less total of a plus b)		15,535,314.03
10. Amount of total net income shown in item 8		17,377,986.62
Less: (a) Excess profits tax (item 12)	$1,842,672.59	
(b) Dividends received (item 3d)	2,699,251.71	
Total (a plus b)		4,541,924.30
11. Amount taxable at 4%		12,836,062.32

DEDUCTIONS

(See corresponding items on back of return.)

4. (a) Cost of goods and other property sold	$20,298,743.99
5. (b) Depreciation charged off	552,505.18
(c) Depletion charged off	3,531,604.52
7. (a) Domestic taxes paid, not including income and excess profits taxes	965,897.08
Total deductions	25,348,750.77

TAX

12. Amount of excess profits tax	$1,842,672.59
13. Amount of 2% tax (2% of item 9a)	310,706.28
15. Amount of 4% tax (4% of item 11)	513,442.49
16. Total tax assessable	2,666,821.36

95 We, the undersigned, president and treasurer of the above-named company, whose return of net income is herein set forth, being severally duly sworn, each for himself, deposes and

says that the items entered in the foregoing report and in the supplementary statement and in any additional list or lists attached to or accompanying this return are, to his best knowledge and belief, true and correct in each and every particular.

WALTER DOUGLAS,
President.
GEORGE NOTMAN,
Treasurer.

Sworn to and subscribed before me this ---------- day of ----------, 19--

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[SEAL OF OFFICER TAKING AFFIDAVIT.]

SUPPLEMENTARY STATEMENT

3. (c) From other sources. Income received from all sources not elsewhere specified should be itemized below:

Commission and discount	$334,481.93
Profit on securities sold	1,687.70
Total	336,169.63

4. (a) Cost of goods and other property sold:

Merchandise bought for sale	2,091,248.99
Cost of manufacturing or otherwise producing goods	19,324,411.68
96 Plus inventories at beginning of year	4,347,386.75
Total	25,763,047.42
Less inventories at end of year	5,464,303.43
Net cost of goods sold	20,298,743.99

5. (b) Depreciation:

Kind of property	Its cost	Probable life after acquirement	Amount of depreciation charged off	
			This year	Previous years
Mining plant, etc.	$12,458,007.70	15 years	$552,505.18	$2,296,430.33

5. (c) Depletion.

Kind of property	Its cost if acquired subsequent to Mar. 1, 1913	Fair market value as of Mar. 1, 1913	Amount of depletion charged off	
			This year	Previous years
Mines		$146,757,827.34	$3,531,606.52	$6,143,404.96

Basis of return.

Is this return made on the basis of actual receipts and disbursements? No.

If not, describe fully what other basis or method was used in computing net income Accrued earnings and expenses.

UNDISTRIBUTED INCOME, SURPLUS, AND UNDIVIDED PROFITS

Total net income of taxable year preceding that for which this return is made	$19,470,862.60
Amount of such income remaining undistributed six months after the close of that year	2,145,862.60
Amount of such income remaining undistributed twelve months after the close of that year	None
Total surplus and undivided profits at close of taxable year	135,500,514.58

97–108 [Omitted in printing.]

109 PLAINTIFFS' EXHIBIT T

MEMORANDUM FOR THE FILES

Dictated by J. L. Darnell, January 27, 1920.

In re tax returns of the Phelps Dodge Corporation, 99 John Street, New York City, for the year 1917

At a conference held to-day with Mr. Matthew C. Fleming, of counsel for the above corporation, it is agreed that the company should be permitted to add to the capital stock $45,000,000, a paid-in surplus of $45,000,000, as of the date of the organization of Phelps Dodge & Company in 1908, it being clearly shown that the values of the various properties as of this date were in excess of $90,000,000.

It is further agreed that the fair market values of the various properties owned or controlled by this corporation as of March 1, 1913, are as follows:

The Copper Queen limestone deposits	$65,369,000
The Copper Queen porphyry deposit	15,355,000
The Moctezuma	25,260,000
Burro Mountain	6,269,000
Morenci	8,832,000
	121,085,000

and that depletion from March 1, 1913, to the end of the taxable year is to be figured on these market values in conjunction with the estimates of recoverable copper, in the various properties, furnished by Mr. Gerald Sherman, the company's engineer, as set out in Schedule 1, statement submitted with schedule for depletion, 1909, to 1917, Form AOM.M.S., which is in the files.

110

It is further agreed that the valuation as of March 1, 1913, of the Stag Canon properties, shall be made in accordance with standard methods employed in the coal valuation section of the natural resources subdivision, and depletion of these coal properties computed by the engineers of the division.

After this is done and the statutory net incomes of the various companies have been determined in accordance with this memorandum, all questions of invested capital will be handled by the consolidated return section.

PLAINTIFF'S EXHIBIT U

TREASURY DEPARTMENT,

IT:T:CR—JZ—2752753

Washington, March 2, 1920.

PHELPS DODGE CORPORATION,
99 John Street, New York, N. Y.

SIRS: An examination of your income and consolidated excess profits tax returns filed by you and your affiliated companies for the calendar year 1917 has been made by this office and adjust-
111 ments have been made in respect to your taxable income and invested capital as outlined in Schedules 1 and 2 attached.

Respectfully,

(Signed) G. V. NEWTON,
Acting Assistant to the Commissioner.

CONSOLIDATED NET INCOME

Schedule 1

Net incomes:		
Phelps Dodge Corporation		$18,272,238.50
Detroit Copper Mining Co		701,967.91
Burro Mountain Copper Co		161,766.37
Stag Canon Fuel Company		53,421.21
Phelps Dodge & Co., Inc		134,370.14
Dawson Fuel Sales Co		7,454.69
Moctezuma Copper Co		3,710,899.77
Phelps Dodge Mercantile Co		808,703.17
Aggregate net income as adjusted		23,850,821.76
Adjustments—deduct dividends received:		
Phelps Dodge Corp	$3,739,251.71	
Detroit Copper Mining Co	100.00	
		3,739,351.71
Consolidated net income for excess profits purpose		20,111,470.05

112 PHELPS DODGE CORPORATION, CONSOLIDATED INVESTED CAPITAL

Schedule 2

Consolidated invested capital for the taxable year ending December 31, 1917, has been fixed as follows:

Par value of capital stock		$45,000,000.00
Paid in surplus		45,000,000.00
Earned surplus to Dec. 31, 1916		10,809,708.81
		100,809,708.81
Reserves:		
For bad debts	$84,981.77	
For 1916 taxes	737,211.76	
		822,193.53
		101,631,902.34

Adjustments by way of additions:		
Realized proportion of depletion due to appreciation	$8,109,572.49	
Excess reserve on books	1,419,968.17	
		$9,528,540.66
		111,160,443.00
Changes during taxable year:		
Deduct taxes for 1916 paid and assessed, $742,504.82, @ 6⅓ mos		404,252.63
Consolidated invested capital for calendar year 1917		110,756,190.37

113 PLAINTIFF'S EXHIBIT V

COPPER QUEEN CONSOLIDATED MINING COMPANY

	Gross income	Depletion per books	Dividends to P. D. & Co.	Depletion per Government figures
1913	$6,798,411.27	$524,469.20	$5,700,000.00	$3,509,727.43
1914	5,836,223.47	411,270.35	4,500,000.00	3,158,244.55
1915	6,290,086.43	534,563.70	7,000,000.00	3,572,104.82
1916	16,474,459.03	3,382,246.75	14,000,000.00	3,920,825.70
	35,399,180.20		31,200,000.00	14,160,902.50

114 PLAINTIFF'S EXHIBIT W

Address reply to
Commissioner of Internal Revenue
And refer to IT:G:P-S-IIP

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington May 3, 1921.

Mr. MATTHEW C. FLEMING,
170 Broadway, New York, N. Y.

SIR: Receipt is acknowledged of your letter of March 19, 1921, in reply to office letter of March 18, 1921.

In reply to your request as to whether it is proper for the company to use the department's depletion figures for the years 1913 to 1917, for the purpose of determining the net earnings of the company for those years, you are advised that article 841 of Regulations 45 permits corporations to correct returns of net income for prior years in which errors or adjustments have been made.

It is, therefore, permissible for the Phelps Dodge Corporation to use the department's depletion figures for the years 1913 to 1917 inclusive, in redetermining the earnings of the corporation for each of these years.

Respectfully,

E. H. BATSON,
Acting Deputy Commissioner.

115 PLAINTIFF'S EXHIBIT X

PHELPS DODGE CORPORATION,
99 John Street, New York, September 24, 1917.

Distribution from reserve for depletion

At a meeting of the trustees of Phelps Dodge Corporation on September 13, 1917, a distribution from the reserve for depletion of three dollars a share was declared, payable September 28, 1917, to all stockholders of record on this date. A check for your share of this distribution is enclosed.

GEORGE NOTMAN, *Treasurer.*

You are requested to deposit this check promptly.

PLAINTIFF'S EXHIBIT Y

PHELPS DODGE CORPORATION,
99 John Street, New York, December 28, 1917.

Distribution from reserve for depletion

At a meeting of the trustees of Phelps Dodge Corporation on December 13, 1917, a distribution from the reserve for depletion of five dollars a share was declared, payable December 28, 1917, to all stockholders of record on December 18, 1917. A check for your share of this distribution is enclosed.

GEORGE NOTMAN, *Treasurer.*

You are requested to deposit this check promptly.

116 PLAINTIFF'S EXHIBIT Z

Phelps Dodge Corporation—distribution from reserve for depletion

$123,150.00 No. 1112

NEW YORK, *Sep. 28, 1917.*

FIRST NATIONAL BANK OF NEW YORK:

Pay to the order of James Douglas one hundred twenty three thousand, one hundred fifty & no/100 dollars.

Good only when countersigned.

Special account.

PHELPS DODGE CORPORATION.
F. K. CAMERON, *Cashier.*

By C. W. PARSONS.

[Indorsement]

Pay to the order of Market & Fulton National Bank. James Douglas.

(By perforating marks:) Paid 9/29/17.

Market & Fulton National Bank. Received payment, Sep. 28, 1917, through N. Y. Clearing House receiving teller.

117 Phelps Dodge Corporation—dividend No. 2 & extra

$205,250.00 No. 652

NEW YORK, *Sep. 28, 1917.*

FIRST NATIONAL BANK OF NEW YORK:

Pay to the order of James Douglas two hundred five thousand, two hundred fifty & no/100 dollars.

Good only when countersigned.

Special account.

PHELPS DODGE CORPORATION.
F. K. CAMERON, *Cashier.*

By C. W. PARSONS.

[Indorsement]

Pay to the order of Market & Fulton National Bank. James Douglas.

(By perforating marks:) Paid 9/29/17.

Market & Fulton National Bank. Received payment Sep. 28, 1917, through N. Y. Clearing House receiving teller.

118 Phelps Dodge Corporation—distribution No. 2 from reserve for depletion

$205,250.00 No. 2159

NEW YORK, *Dec. 28, 1917.*

FIRST NATIONAL BANK OF NEW YORK:

Pay to the order of James Douglas two hundred five thousand, two hundred fifty & no/100 dollars.

Good only when countersigned

Special account.

PHELPS DODGE CORPORATION.
F. K. CAMERON, *Cashier.*

By C. W. PARSONS.

[Indorsement]

Pay to the order of Market & Fulton National Bank. James Douglas.

(By perforating marks:) Paid 12/29/17

Market & Fulton National Bank. Received payment Dec. 28, 1917, through N. Y. Clearing House receiving teller.

119 Phelps Dodge Corporation—dividend No. 3 & extra

$205,250 00 No. 1652

NEW YORK, *Dec. 28, 1917.*

FIRST NATIONAL BANK OF NEW YORK:

Pay to the order of James Douglas two hundred five thousand, two hundred fifty & no/100 dollars.

Good only when countersigned

Special account.

PHELPS DODGE CORPORATION.
F. K. CAMERON, *Cashier.*

By C. W. PARSONS.

[Indorsement]

Pay to the order of Market & Fulton National Bank. James Douglas.

(By perforating marks:) Paid 12/29/17.

Market & Fulton National Bank. Received payment Dec. 28, 1917, through N. Y. Clearing House receiving teller.

120 PLAINTIFF'S EXHIBIT A1

Phelps Dodge Corporation

Memorandum of various accounts which combined represent the reserve for depletion shown in published consolidated accounts as 31st, December, 1917.

On books of Phelps Dodge Corporation:	
Depletion reserve—Copper Queen (page 9 of ledger)	$7,948,050.29
Depletion reserve—Morenci (page 9 of ledger)	982,609.95
Depletion reserve—Burro Mountain (page 9 of ledger)	476,075.00
Depletion reserve—Stag Canon (page 14 of ledger)	268,274.24
Ore reserve—Copper Queen (page 10 of ledger)	22,964,685.91
Ore reserve—Morenci (page 10 of ledger)	2,905,368.56
Reserve for depletion (page 58 of ledger)	3,600,000.00
Total of various accounts on books of Phelps Dodge Corporation	31,945,063.95
On books of Moctezuma Copper Co.:	
Reserve for depletion	$3,701,774.74
Ore reserve	4,970,649.26
121 Total of various accounts on books of Moctezuma Copper Company	8,672,424.00
Total of various accounts on books of Phelps Dodge Corporation	31,945,063.95
Moctezuma Copper Company	8,672,424.00
	40,617,487.95
Add, for consolidation purposes, elimination of amount of distribution from depletion reserve, charged by Moctezuma Copper Co. on its books against reserve for depletion, paid to Phelps Dodge Corporation	1,040,000.00
Amount per published accounts 31st December, 1917	41,657,487.95

122 PLAINTIFFS' EXHIBIT A2

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER OF INTERNAL REVENUE,
Washington, April 22, 1920.

Messrs. OSBORN, FLEMING & WHITTLESEY,
71 Broadway, New York, N. Y.

SIRS: Reference is made to your letter of March 26, in re claims for the refund of taxes on 1917 depletion dividends. You particularly call attention to the following claims:

Estate of Dr. James Douglas (George Notman & others executors)	$173,579.72
Cleveland H. Dodge	176,837.40
Mary M. H. Dodge	104,343.17

The claim of the estate of Dr. James Douglas for the refund of $173,579.72 has already been rejected. The claim was for the refund of taxes paid upon cash dividends specifically declared and paid between September 28 and December 31, 1917, out of depletion reserves of mining companies, even though at the time that the dividends were declared the company had on hand a surplus earned subsequent to February 28, 1913, out of which the amount of the dividends could have been distributed.

The claim was rejected under section 31 of the revenue
123 act of September 8, 1916, added by section 1211 of the act of October 3, 1917. That section provides as follows:

"(a) That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, * * *

"(b) Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth,
124 nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen."

The gist of your contention appears to be that the words of the provision "shall be deemed to have been made from the most recently accumulated undivided profits or surplus" create a presumption only that the dividends are paid out of such undivided profits or surplus, and that the presumption is subject to rebuttal by the presentation of evidence that the dividends were not paid out of such funds.

A statute which provides that a thing is to be "deemed" to be true, creates more than a disputable presumption; the matter must be considered as conclusively adjudged and established. Thus, in the case of Cardinel v. Smith, Fed. Cas. No. 2395, it was said:

"* * * Their counsel, apparently conscious that the letter of this section was against them, sought to modify its effect, by endeavoring to show that when it declares that 'a person who shall

offer or expose for sale, any of the articles named in Schedule C, * * * shall be deemed the manufacturer thereof,' it only creates a disputable presumption that such person is 'the manufacturer thereof,' which, in this case, is overcome by the admitted fact, that the plaintiffs are not the manufacturers, but only the vendors of the articles. The word 'deemed' in this connection means 'judged,' 'determined'; and when it is enacted that the vendor of an
125 article shall for any purpose, 'be deemed the manufacturer thereof,' for such purpose, he is to be absolutely considered such manufacturer. Indeed, it would be of little use for congress to declare that a vendor of canned goods, for the purpose of internal revenue, should be deemed a manufacturer thereof, if such declaration could be overcome and held for naught, by showing that, in fact, he was not such manufacturer."

And again, in the case of Leonard v. Grant, 5 Fed. 11, the court said:

"The word 'deemed' is the equivalent of 'considered' or 'judged'; and, therefore, whenever an act of congress requires to be 'deemed' or 'taken' as true of any person or thing, must, in law, be considered as having been duly adjudged or established concerning such person or thing, and have force and effect accordingly."

You contend further that since the unit values for depletion purposes represented the value of the ores on March 1, 1913, any distributions made from reserves for depletion were really distributions of amounts realized from the sale of capital assets in existence on March 1, 1913, and were not distributions from reserves accumulated subsequent to March 1, 1913. It has been held, however, that proceeds derived from mining operations constitute income and not merely converted capital. Stratton's Independence v. Howbert, 231 U. S. 399; Stanton v. Baltic Mining Co., 240 U. S. 103; von
126 Baumbach v. Sargent Land Co., 242 U. S. 503; Goldfield Consol. Mines Co. v. Scott, 247 U. S. 126. In the first case the court said:

"It is not correct, from either the theoretical the practical standpoint, to say that a mining corporation is not engaged in business, but is merely occupied in converting its capital assets from one form into another. The sale outright of a mining property might be fairly described as a mere conversion of the capital from land into money. But when a company is digging pits, sinking shafts, tunneling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing capital and labor in transmuting a part of the realty into personalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacturing process. And, however the operation shall be described, the transaction is indubitably 'business' within the fair meaning of the act of 1909; and the gains derived from it are properly and strictly the income from that business; for 'income' may be defined as the

gain derived from capital, from labor, or from both combined, and here we have combined operations of capital and labor."

And in the case of Stanton v. Baltic Mining Co., supra, the court said:

"But it is said that although this be undoubtedly true as a general rule, the peculiarity of mining property and the exhaustion
127 of the ore body which must result from working the mine, causes the tax in a case like this where an inadequate allowance by way of deduction is made for the exhaustion of the ore body to be in the nature of things a tax on property because of its ownership and therefore subject to apportionment. Not to so hold, it is urged, is as to mining property but to say that mere form controls, thus rendering in substance the command of the Constitution that taxation directly on property because of its ownership be apportioned, wholly illusory or futile. But this merely asserts a right to take the taxation of mining corporations out of the rule established by the sixteenth amendment when there is no authority for so doing. It moreover rests upon the wholly fallacious assumption that looked at from the point of view of substance a tax on the product of a mine is necessarily in its essence and nature in every case a direct tax on property because of its ownership unless adequate allowance be made for the exhaustion of the ore body to result from working the mine. We say wholly fallacious assumption because independently of the effect of the operation of the sixteenth amendment it was settled in Stratton's Independence v. Howbert, 231 U. S. 399, that such a tax is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations."

It appears to this office, therefore, that it was clearly the intention of Congress that all dividends paid by a going concern
128 should be taxed as though they had been paid from the most recently accumulated profits and surplus. It is not believed that it is competent for a corporation to declare a dividend out of profits earned prior to March 1, 1913, or from a depletion reserve, and escape tax while in point of fact the company has earnings in its surplus fund which accrued to it on and after March 1, 1913, and from which the dividend, or dividends could have been paid.

This office is endeavoring now to locate the claims and returns of Cleveland H. Dodge and Miss Mary M. H. Dodge, and when they are located the claims of these individuals will be respected, if the facts are the same as contained in the case of the claim of the estate of Dr. James Douglas.

Respectfully,

(Sgd.) WAYNE JOHNSON,
Solicitor.

128a

DEFENDANT'S EXHIBIT 1

INDIVIDUAL INCOME TAX RETURN FOR CALENDAR YEAR 1917

Made by James Douglas. Home address, Spuyten Duyvil, N. Y. City. Business, 99 John St., New York, N. Y.

Details of taxable income

A. Income from salaries, wages, commissions, bonuses, directors' fees, and pensions, and from professions.

By whom received	Occupation or profession	Name and address of employer or (if practicing a profession) office address	Gross income	
James Douglas	Executive	Phelps Dodge Corp., 99 John St., New York	$30,000.00	
		El Paso & Southwestern R. R. Co., 99 John St., New York, N. Y.	7,500.00	
Net income from salaries			37,500.00	$37,500.00

C. Profit from sale of real estate, stocks, bonds, and other property.

	Sale price	Original cost or market value March 1, 1913	
100 Marlin Arms, 1915, Marlin Arms Co., N. Y. C. Pref. Stk. 1915	$10,000.00	$9,000.00	
$20,000 Detroit Edison Bds. Mabon & Co., Wall St., N. Y.	28,716.00	21,683.33	
1,000 shs. Commercial Mining Co., Stk. Bot. 1894 for $100,000; sold Phelps Dodge Corp., 99 John St., N. Y. C.	15,000.00	15,000.00	
Totals	53,716.00	45,683.33	
Net profit from sales			$8,032.67

D. Income from rents and royalties.

	Amount of rent and royalties	Repairs, wear and tear, and property losses	Taxes	Other expenses
11 small tenant houses at Hudson Pk., N. Y. C., and one frame and brick house at 124 Cedar Ave., Montreal, Canada	$5,559.35	$1,292.90	$1,900.15	$544.64
Net income from rents and royalties				1,821.66

128b F. Dividends on stock of corporations organized or operating in the United States and subject to income tax.

If not received directly, state name of partnership or fiduciary through whom received.	Accumulated in 1913	Accumulated in 1914	Accumulated in 1915	Accumulated in 1916	Accumulated in 1917
	$453.00	$237.00	$225.00	$319,860.78	$1,098,287.65
Totals	453.00	237.00	225.00	319,860.78	1,098,287.65
Total net income from sources A, B, C, D, E, and F, reported on page 3					1,145,641.98

G. Interest on tax-free-covenant bonds (on which one normal tax of 2 per cent was withheld as source).

	Gross income	Deductions, if any	
Net interest on tax-free-covenant bonds (total column 1 minus total column 2)	$34,353.17	$385.42	$33,967.75

H. Other income (including income from partnerships and fiduciaries, except that reported under E, F, and G).

		Gross income
Interest on bonds and other obligations of domestic and resident corporations (except as entered under G), net		$7,741.00
Interest on bonds of foreign countries and corporations and dividends on stock of foreign corporations		24,072.44
Interest on notes, bank deposits, mortgages (except of corporations), and all other interest:		
(a) On notes	$18.30	
(b) On bank deposits	7,324.38	
(c) On mortgages (except corps.)	16,193.16	
(d) On all other interest	1,455.08	
	24,990.92	
		56,804.36

I. Total net income from all sources	$1,236,414.09
J. General deductions not reported on page 3 or above (except contributions—see N below).	

Interest on personal indebtedness		$165.85
Taxes on dwelling and personal property, and other taxes not reported above (see instructions on page 2)		14,277.08
Other deductions, except contributions (explain):		
Salaries of attornies, secretary, office expense	$14,974.07	
Rent paid, under lease, on property sub-leased	2,466.00	
Bad debt—loan to E. C. Douglas—January, 1914; no relative; Mr. D. ill, and no prospect of recovery	6,750.00	
	24,190.07	
Total general deductions, except contributions		$38,633.00

128c K. Total net income (without deducting excess profits taxes or contributions)	$1,197,781.09
L. Less excess profits taxes, if any, for 1917 (see instructions on page 1 under "Excess profits taxes")	2,520.00
M. Total net income (without deducting contributions) (K minus L)	1,195,261.09
N. Contributions to charitable organizations, etc. (Enter below name and address of each organization and amount paid to each.)	
Total of large gifts listed on detail sheet $460,444.96	
Total (not over 15 per cent of item M) 320,775.78	227,405.53
O. Total net income on which income tax is to be computed (M minus N)	967,855.56
18. Total net income on which income tax is to be computed	967,855.56
19. Less: Excess of interest received on obligations of United States issued since Sept. 1, 1917	00.00
20. Dividends	1,098,287.65
21. Personal exemption	2,000.00
22. Total of items 19, 20, and 21	1,100,287.65

23.	Balance (item 18 minus item 22)	$00.00
24.	Add excess of interest paid on indebtedness incurred for purchase of obligations of United States issued since Sept. 1, 1917 (item E, total of column 6)	00.00
128d 25.	Amount subject to normal tax of 2 per cent under act Oct. 3, 1917	00.00
26.	Less additional exemption	2,000.00
27.	Amount subject to normal tax of 2 per cent under act Sept. 8, 1916	00.00
28.	Normal tax of 2 per cent on amount of item 25	00.00
29.	Additional normal tax of 2 per cent on amount of item 27	00.00
30.	Total normal tax	00.00
31.	Less tax withheld on tax-free-covenant bonds	679.35
32.	Balance of normal tax due	00.00
33.	Surtax	417,620.56
34.	Excess profits tax at rate of 8 per cent	2,520.00
	struction 7, page 1)	2,520.00
35.	Excess profits tax on income from business with invested capital, as computed on excess profits tax return	420,140.56
37.	Additional assessments and penalties	34,918.14
		455,058.70

I swear (or affirm) that this return, including the accompanying schedules (if any), to the best of my knowledge and belief, is a true and complete statement of all taxable gains, profits, and income received by me during the year 1917, and that I am entitled to all deductions and exemptions entered or claimed herein.

JAMES DOUGLAS.

Sworn to and subscribed before me this 28th day of Mar., 1918.

BERTHA M. HUNT,
Notary Public.

128e NOTE.—In addition to the monies received during the year 1917 as reported in the foregoing individual income tax return for 1917, I have received the following amounts:

1917			
Sept.	28.	Rec'd as a stockholder, from the Phelps Dodge Corporation, 99 John St., New York, N. Y., "a distribution from reserve for depletion"	$123,150.00
Dec.	28.	Do	205,250.00
		Total	328,400.00
		The Phelps Dodge Corp., owner and operator of Mines, advised 1/29/17 that these two distributions are distributions of the proceeds of the sale of capital assets in existence March 1, 1913. These amounts are therefore not included in the return.	
Sept.	25.	Rec'd as a stockholder, from the Calumet and Arizona Mining Company, Calumet, Mich., a check paid as a capital distribution of $1.00 per share of stock held	1,165.00
		The Calumet & Arizona Mining Co. advises 1/25/18, that this sum was paid out of reserve for depreciation and reserve for depletion of mines set up in 1915 and 1916.	

Jan.	20.	Rec'd as a stockholder, from the Shattuck-Arizona Copper Co., 120 Broadway, New York, N. Y., a check as a capital distribution No. 1	$75.00	
Apr.	20.	" No. 2	75.00	
July	20.	No. 3	75.00	
Oct.	20.	No. 4	75.00	
		Total		$300.00

On Jan. 25, 1918, the Shattuck-Arizona Copper Co. advises that capital distributions No. 1 and 54.95% of No. 2 were paid from reserves for depletion of mines accumulated during 1916, and the balance of No. 2 and the whole of No. 3, No. 4, and No. 5 (No. 5 pd. in 1918) were paid from like reserves accumulated during 1917.

329,805.00

As these receipts were capital distributions they are not included in the return for 1917.

128f Memorandum of dividends received in the year 1917 from corporations paid from profits accrued in the year 1916, as shown in the total of col. 5 of block "F" on page 3 of income tax return for 1917:

Phelps Dodge Corp., 99 John St., New York		$246,300.00
Old Dominion Co., 50 Congress St., Boston, Mass.		48,720.00
Atch. Top. & Sa. Fe Ry. Co., 32 Nassau St., New York:		
Preferred stock div'd	2102.00	
Common stock div'd	124.56	
		226.56
Great Northern Ry. Co. pref., Nassau St., N. Y.		625.94
United Verde Extension Mining Co., 233 Bdway., N. Y. C.		14,375.00
Bisbee Improvement Co., Bisbee, Ariz.		352.00
Douglas Investment Co., Douglas, Ariz.		875.00
Morenci Water Co., Morenci, Ariz.		875.00
Calumet & Arizona Mining Co.		3,315.00
Internat. Nickel Co., 43 Exchange Pl., N. Y. C.:		
Preferred stock div'd	$375.00	
Common stock div'd	822.00	
		1,197.00
Montana Power Co. pref. st., 42 Bdway, N. Y. C.		262.50
Prescott State Bank, Prescott, Ariz.		510.00
Mississippi Glass Co., common st., 220 Fifth Av., N. Y.		28.00
Cuba Cane Sugar Co., pref. stk., 122 Wall St., N. Y. C.		525.00
American Woolen Co., Boston, Mass.		175.00
Marlin Arms Co. pref. stk., New York, N. Y.		47.84
United Alloy Steel Corp., Canton, Ohio		300.00
Shattuck-Ariz. Copper Co., 120 Broadway, N. Y. C.		50.00
Moline Plow Co., 1st pref. st., Moline, Ill.		350.00
American Bank Note Co., pref. stk., 70 Broad St., N. Y.		180.00
Lehigh Valley R. R. Co., com. st., Philadelphia, Pa.		222.50
Lucky-Tiger Comb. Gold Mng. Co., 1012 Balto. Av., Kansas City		301.50
Independent Corp., 119 W. 40th St., N. Y. Co.		210.00
Total from 1916 profits		319,800.78
In addition the North Star Mines Co., 22 William St., N. Y. C., paid divds. in 1917 from profits accrued in the following years:		
1913		453.00
1914		247.00
1915		225.00
Total amount on which additional assessment is to be paid		320,775.78

129 DEFENDANT'S EXHIBIT 2

CLAIM FOR REFUND

Taxes erroneously or illegally collected; also amounts paid for stamps used in error or excess

STATE OF NEW YORK,
County of New York, ss:

George Notman, Edmund Coffin, and Archibald Douglas, as executors of the estate of James Douglas, deceased, 99 John Street, New York, N. Y.

This deponent being duly sworn according to law deposes and says that this claim is made on behalf of the claimant named above, and that the facts stated below with reference to the claim are true and complete:

1. Business engaged in by claimant executors of decedent's estate.
2. Character of assessment or tax income and excess profits for year 1917.
3. Amount of assessment or stamps, $639,638.42.
4. Amount now asked to be refunded (or such greater amount as is legally refundable), $173,579.72.
5. Date of payment of assessment or purchase of stamps.

Deponent verily believes that the amount stated in item 4
130 should be refunded and claimant now asks and demands refund of said amount for the following reasons:

(The attached statement of seven pages, being too long for insertion here, is hereby made a part of this affidavit, with the same force and effect as though written in this space.)

And this deponent further alleges that the said claimant is not indebted to the United States in any amount whatever, and that no claim has heretofore been presented, except as stated herein, for the refunding of the whole or any part of the amount stated in item 3.

Signed ARCHIBALD DOUGLAS,
GEORGE NOTMAN,
EDMUND COFFIN,
Executors of the estate of James Douglas, deceased.

Sworn to and subscribed before me this 14th day of November, 1919.

EDWARD HOLLOWAY.

Dr. James Douglas, on March 28, 1918, filed with the collector of internal revenue, second district, New York, his income tax statement for the taxable year 1917, in accordance with the provisions of Title I of an act of Congress approved September 8th, 1916, as amended October 3d, 1917 showing a net income subject to
131 tax amounting to $967,855.56 and thereafter duly paid on June 11th, 1918, the tax thereon amounting to $455,058.70. A

copy of the receipt thereof is hereto annexed and marked "Exhibit 1."

To his return there was attached and filed and for the purpose of advising the Treasury Department of the receipt of the amounts therein set forth, a statement as follows:

"NOTE.—In addition to the monies received during the year 1917 as reported in the foregoing individual income tax return for 1917, I have received the following amounts:

1917.			
Sept.	28.	Rec'd, as a stockholder from the Phelps Dodge Corporation, 99 John Street, New York, N. Y., "a distribution from reserve for depletion"	$123,150.00
Dec.	28.	Do	205,250.00
		Total	328,400.00
		The Phelps Dodge Corp., owner and operator of mines, advised 1/29/17, that these two distributions are distributions of the proceeds of the sale of capital assets in existence March 1, 1913. These amounts are therefore not included in the return.	
Sept.	25.	Rec'd, as a stockholder, from the Calumet and Arizona Mining Company, Calumet, Mich., a check paid as a capital distribution of $1.00 per share of stock held	1,105.00
132		The Calumet & Arizona Mining Co. advises, 1/25/18, that this sum was paid out of reserve for depreciation and reserve for depletion of mines set up in 1915 and 1916.	
Jan.	20.	Rec'd as a stockholder from the Shattuck-Arizona Copper Co., 120 Broadway, New York, as a Capital Distribution No. 1	$75.00
Apr.	20.	" " " 2	75.00
July.	20.	" " " 3	75.00
Oct.	20.	" " " 4	75.00
		Total	300.00
		On Jan. 25, 1918, the Shattuck-Arizona Copper Co. advises that Capital Distributions No. 1 and 54.95% of No. 2 were paid from Reserves for Depletion of Mines accumulated during 1916, and the balance of No. 2 and the whole of No. 3, No. 4, and No. 5 (No. 5 pd. in 1918) were paid from like Reserves accumulated during 1917.	
			329,805.00

"As these receipts were capital distributions they are not included in the return for 1917."

Thereafter a letter was received from the Treasury Department, Washington, D. C., dated February 20th, 1919, copy of which is hereto annexed and marked "Exhibit 2," in which letter it was claimed by the said Treasury Department that there was upon
133 investigation an additional tax for the year 1917, amounting to $173,579.72 and giving the following calculation:

1917

Dividends 1913–1915	$915.00	
Dividends 1916	319,860.78	
Gross Income		$1,566,114.09
Deductions		31,883.00

Net income		$1,534,231.09
Less excess profits tax		2,520.00
Total		1,531,711.09
Less contributions		277,873.03
		1,253,838.06
Less 1917 dividends		1,427,987.65
Normal tax	None.	
Super tax	$590,141.22	
Tax on 1915 dividends	54.90	
Tax on 1916 dividends	35,921.67	
Excess profits tax	2,520.00	
Total	628,637.79	
Tax paid	455,058.07	
Additional tax due	173,579.72	

Upon receipt of this letter and through the attorneys of said James Douglas, he inquired from the Treasury Department the reason for this tax, a copy of which inquiry is hereto attached and marked "Exhibit 3," to which the Treasury Department answered on April 22nd, 1919, a copy of which is hereto attached and
134 marked "Exhibit 4," stating with reference to the 1917 income tax as follows:

"The increase to gross income in 1917 of over $329,000 is the result of including as 1917 income the amount claimed as a depletion dividend, and not returned; examination of the accounts of the Phelps Dodge Company, paying this dividend, show a surplus and undivided profit available for such dividend greatly in excess of this amount and which under the law will be deemed to have been paid from such reserve."

This of course refers to the amount received as depletion dividends of which James Douglas advised the department in the statement attached to his return and above set forth. By using the words "by over $329,000" the collector has included the two small items of $1,105 paid as a depletion dividend by the Calumet & Arizona Mining Company and the $300 paid by the Shattuck-Arizona Copper Company.

On June 25th, 1918, Dr. James Douglas died at Spuyten Duyvil, New York. Thereafter his will was duly filed and admitted to probate in the Surrogate's Court of Bronx County on the 22nd day of August, 1918, and George Notman, Edmund Coffin, and Archibald Douglas, above named, were duly appointed his executors.

Thereafter and upon demand and threat of distress by the collector of internal revenue, second district, N. Y., the executors of the estate of said James Douglas, deceased, paid under protest and
135 against their will, the amount of $173,579.73 being the tax levied and assessed on said depletion dividends.

Now, wherefore, the undersigned state that the amount of $328,400 paid by the Phelps Dodge Corporation to the late James Douglas in the year 1917, was not as alleged in the letter of the Treasury Department, dated April 22nd, 1919, a distribution from the sur-

plus or undivided profits of the Phelps Dodge Corporation, but the payment out of reserve for depletion set aside by said Phelps Dodge Corporation in accordance with the income tax law applicable to corporations, and that is was a distribution to the stockholders and to said James Douglas of capital and not income.

The undersigned state that the amount of $1,105 paid by the Calumet and Arizona Mining Company to the late James Douglas in the year 1917 was not a distribution from surplus or undivided profits by the Calumet and Arizona Mining Company, but was a payment out of the reserve for depletion set aside by said corporation in accordance with the sections of the income tax law applicable to corporations, and that it was a distribution to the stockholders and to said James Douglas of capital and not income.

The undersigned state the amount of $300 paid by the Shattuck-Arizona Copper Company to the late James Douglas, in the year 1917, was not a distribution from the surplus or undivided profits of the Shattuck-Arizona Copper Company, but was a payment out of the reserve for depletion set aside by said corporation in accordance with the provisions of sections of the income tax
136 law applicable to corporation, and that it was a distribution to the stockholders and to the said James Douglas of capital and not income.

That the levy on the part of the Treasury Department of the income tax on the sum of $329,700 is an attempt to levy a direct tax upon the capital or property of the late James Douglas, but without apportionment among the States in proportion to the population as required by subdivision 4, section 9 of article 1 of the Constitution of the United States. That said levying of a tax on the said $329,700 is an attempt to tax as income what was in fact capital or property of the said late James Douglas and not income within the provisions of article 16 of the Constitution of the United States.

That the said tile 1 of the act of September 8th, 1916, as amended by the law of October 3, 1917, and in particular sec. 31 thereof, as so construed and applied by the Treasury Department in respect to the levying of the said tax on said $329,700 is an attempt to levy a tax upon income which had accrued or been earned before March 1st, 1913, and contrary to the sixteenth amendment of the Constitution of the United States.

That the said title 1 of the act of September 8, 1916, as amended by the law of October 3, 1917, and in particular sec. 31 thereof, as so construed and applied by the Treasury Department in respect to the levying of the said tax on said $329,700 is an attempt to levy a tax upon the capital or property of the late James Douglas owned by him before March 1st, 1913, and therefore contrary to the provisions of the Constitution of the United States.

137 That the said tile of said acts of Congress make, in respect of said tax, arbitrary and unreasonable discriminations, exceptions, exemptions, and classifications, in violation of fundamental requirements of the Constitution of the United States,

and the requirement therein that taxes shall be uniform throughout the United States.

In sundry other particulars, both in form and substance, the said act of Congress purporting to impose said tax, and the rules and regulations promulgated in connection therewith by the Commissioner of Internal Revenue or the Secretary of the Treasury, and the demand and requirement to make said return and pay said sum, are all and each of them illegal and unconstitutional, and notice is hereby given that in such time and in such manner as may be advisable, appropriate proceedings including any action in law or in equity that may be deemed constitutional, will be taken against you by any and all parties in interest in said sum and to preserve and protect all our rights and interest thereunto appertaining.

Wherefore, the undersigned demand that the sum of $173,579.72 paid under duress and under protest and illegally assessed, be refunded and paid back to the said executors above named.

Nothing in this claim shall be construed as an admission, waiver, or surrender of any rights that the undersigned or anyone interested in the estate may have.

138 EXHIBIT 1 (ATTACHED TO CLAIM FOR REFUND)

Form 1108

United States Internal Revenue. Memorandum for taxpayer—Income and excess profits tax for 1917

INSTRUCTIONS TO TAXPAYER

Detach this part of the form and retain it as a record of the payment of your tax unless you want a receipt other than the endorsement on your check. If a receipt is desired forward this part of the form and the notice with your remittance. Otherwise no receipt will be issued.

2414831 James
Douglas
99 John St.
New York, N. Y. $455058.70

TAXPAYER'S RECORD

Check No. ---------- Money order No. ----------

Office of issue

Bank----------

Date---------- Date----------

(Stamp)

Income tax

Excess profits tax

Total

Office of the collector of Internal revenue 2nd district

June 11, 1918
Receipt

EXHIBIT 2 (ATTACHED TO CLAIM FOR REFUND)

IT:RAA:P—SC

TREASURY DEPARTMENT,
Washington, Feb. 20, 1919.

DOUGLAS, ARMITAGE & MCCANN,
Woolworth Building, 233 Broadway, New York, N. Y.

SIRS: An investigation of the income tax liability of the
139 late James Douglas, 99 John Street, New York City, N. Y., for the years 1915 to 1917, inclusive, based on a revenue

agent's report and an audit in this office, indicates that there are further taxes due of $85.19 for the year 1915, $1,059.01 for 1916 and $173,579.72 for 1917.

The amended returns should read as follows:

1915

Gross income		$1,201,836.98
General deductions		81,268.20
Net income		1,120,568.78
Dividends	$1,071,257.37	
At source	89,176.42	
Exemption	4,000.00	
Total		1,164,433.79
Normal tax	None.	
Additional tax	57,284.12	
Tax previously paid	57,198.93	
Additional tax due	85.19	

1916

Gross income		1,899,675.99
General deductions		110,268.81
Net income		1,789,407.18
Dividends	1,757,561.97	
Exemption	4,000.00	
Total		1,761,561.97
Income subject to normal tax		27,845.21
140 Normal tax	566.90	
Super tax	172,728.86	
Total tax due	173,285.76	
Tax paid	172,226.66	
Additional tax due	1,059.10	

1917

Dividends 1913–1915	915.00	
Dividends 1916	319,860.78	
Gross income		1,566,114.09
Deductions		31,883.00
Net income		1,534,231.09
Less excess profits tax		2,520.00
Total		1,531,711.09
Less contributions		277,873.03
		1,253,838.06
Less 1917 dividends		1,427,987.65
Normal tax	None.	
Super tax	590,141.22	
Tax on 1915 dividends	54.90	
Tax on 1916 dividends	35,921.67	
Excess profits tax	2,520.00	
Total	628,637.79	
Tax paid	455,058.07	
Additional tax due	173,579.72	

141 Assessment of the above amounts will be made on the next list sent to the collector of your district.

Respectfully,

HOWARD H. PACE,
Acting Deputy Commissioner.

EXHIBIT 3 (ATTACHED TO CLAIM FOR REFUND)

FEBRUARY 28, 1919.

COMMISSIONER INTERNAL REVENUE,
Treasury Department, Washington, D. C.

Estate James Douglas

DEAR SIR: Referring to your letter of February 20, 1919, marked IT:RAA:PSC, relating to the income tax returns of James Douglas for the taxable years 1915, 1916, and 1917, will you kindly advise us of the reason of your reduction in the general deductions in the income tax statement for 1915 from $82,688.20 to $81,268.20, resulting in an additional tax of $85.19. We wish to know what items you have disallowed and the reason.

Referring to the 1916 returns, will you kindly advise us of the reason for the reduction in the general deductions from $114,453.81 to $110,268.81.

Referring to the 1917 return, will you kindly advise us why the gross income has been increased by $329,700 and the general deductions reduced by $6,700.

142 We will greatly appreciate an immediate reply to our inquiry in order that we may be apprised before bills are sent us by the collector of New York.

Yours very truly,

DOUGLAS, ARMITAGE & MCCANN,
By EDWARD HOLLOWAY.

EH/P

EXHIBIT 4 (ATTACHED TO CLAIM FOR REFUND)

TREASURY DEPARTMENT,
Washington, Apr. 23, 1919.

IT:IA:RAA:P

DOUGLAS, ARMITAGE & MCCANN,
Woolworth Bldg., 233 Broadway, New York, N. Y.

SIRS: This office is in receipt of your letters of February 28 and April 1, 1919, relative to further tax found due on the income of the late James Douglas as based upon the report of a revenue agent and an audit by this office, as advised in office letter of February 20, 1919.

In reply you are advised that the general deductions for 1915 were reduced to $1,420 through disallowance of excess depreciation claimed, the taxpayer having included for this purpose the value

of the land as well as the improvements. The general deduc-
143 tions for 1916 were reduced $4,185 by the disallowance of $2,235.00 losses claimed because the same were not incurred in trade and no income from similar sources was returned. As in 1915, depreciation was reduced to $300.00, a fair allowance upon the property involved, a disallowance of $1,950 on the amount claimed.

The increase of gross income in 1917 by over $329,000 is the result of including as 1917 income the amount claimed as a depletion dividend, and not returned, examination of the accounts of the Phelps Dodge Co., paying this dividend, showing a surplus and undivided profit available for such dividend greatly in excess of this amount and which under the law will be deemed to have been paid from such reserve.

J. H. CALLAN,
Assistant to the Commissioner.

EXHIBIT 5 (ATTACHED TO CLAIM FOR REFUND)

Letter of Protest filed with payment of tax. Printed in full on page 20 et seq.

144 EXHIBIT 6 (ATTACHED TO CLAIM FOR REFUND)

Form 1–17b—Revised, MAY 5, 1919.

United States Internal Revenue. Demand for payment of income and excess profits tax for 1917

OFFICE COLLECTOR OF INTERNAL REVENUE,
2nd Dist., Custom House, N. Y.

Demand is hereby made for the amount of income and excess profits tax stated opposite your name. Failure to pay this tax on or before the due date given below will cause a 5 per cent penalty to accrue with interest at 1 per cent per month from the due date until paid.

WM. H. EDWARDS,
Collector of Internal Revenue.

Wash. List. Jan. 1919, F–6 L–13
2414831—1917

James Douglas, 99 John St. $173,579.72. Date due, May 16, 1919.

This part of the form must be sent to the collector with remittance. Disregard previous notices.

145 In United States District Court

Stipulation settling bill of exceptions

It is stipulated that the foregoing bill of exceptions contains all the evidence, exhibits, rulings of the court, and exceptions upon the

trial of this action and may be settled, order to be filed, and annexed to the judgment roll herein.

New York, May 14, 1923.

DOUGLAS, ARMITAGE & MCCANN,
Attorneys for Plaintiffs.
WM. HAYWARD,
U. S. Attorney, Attorney for Defendant.

In United States District Court

Order settling bill of exceptions

Upon the above stipulation the foregoing bill of exceptions, containing all the evidence, exhibits, rulings of the court and exceptions upon the trial of this action, is hereby settled and ordered on file.

May 14, 1923.

JULIAN W. MACK,
United States District Judge.

146 In United States District Court

Order allowing writ of errors

[Title omitted.]

Considering the foregoing petition this day presented, it is

Ordered that writ of error be allowed to Archibald Douglas, George Notman, and Edmund Coffin as executors of the estate of James Douglas, deceased, the petitioners and plaintiffs in this suit, from the judgment and decree of December 22, 1922, rendered against plaintiffs in the above entitled cause, and that said appeal shall be returnable to the United States Circuit Court of Appeals for the Second Circuit, and that upon the execution of a bond in the penalty of $250.00 said appeal shall operate as a supersedeas of said decree and shall suspend until the final decree on appeal herein the effect of the judgment herein, and that a transcript of a record, including all of the exhibits offered in evidence by either party be filed in the United States Circuit Court of Appeals according to law as prayed for.

Dated, May 15, 1923.

HENRY W. GODDARD,
Judge of the U. S. Dist. Court.

147 In United States District Court

Petition for writ of errors

[Title omitted.]

The petition of the plaintiffs, by their attorneys, Douglas, Armitage & McCann, herein respectively presents:

The petitioners are aggrieved by the judgment and decrees herein rendered, on the twenty-second day of December, 1922, in favor of

the defendant and against the complainant, dismissing the plaintiff's complaint and directing judgment for $21.15 costs, and that the plaintiffs have execution therefor, and that the petitioners for the reason specified in the assignment of errors filed herewith desire to appeal from said judgment and decree, and desire that said appeal, returnable to the Circuit Court of Appeals of the Second Circuit, shall operate as supersedeas and may suspend during the pendency of said appeal the execution of the said judgment.

148 Wherefore, your petitioners pray that the said appeal may be allowed and that upon giving bond in an amount to be fixed by this court the said appeal may operate as a supersedeas and may suspend during the pendency of the said appeal the execution of the said judgment; that said appeal be made returnable to the United States Circuit Court of Appeals for the Second Circuit, according to law, and that a transcript of the records, proceedings, papers, and exhibits upon which said decree was rendered, duly authenticated, be sent to said Circuit Court of Appeals.

Dated, May 15, 1923.

DOUGLAS, ARMITAGE & MCCANN,
Attorneys for the Plaintiffs,
233 Broadway, New York, N. Y.

149 In United States district court

Assignment of errors

[Title omitted.]

And now on the 11th day of May, 1923, came the said plaintiffs, by Douglas, Armitage & McCann, their attorneys, and say:

That the judgment and decree in said cause is erroneous and against the just rights of said plaintiffs for the following reasons:

1. That the court erred in refusing to direct a verdict for the plaintiffs for $173,579.72, with interest and costs.

2. That the court erred in refusing to direct a verdict for the plaintiffs.

3. That the court erred in directing a verdict for the defendant.

4. That the court erred in holding and deciding that the claim for refund "was properly rejected."

150 5. That the court erred in holding and deciding that the word "distribution," as used in section 31–a and 31–b of the revenue act of 1916, as amended in 1917, referred solely to dividends in the ordinary courses of business.

6. That the distributions in question were liquidating dividends specifically declared and made from a depletion reserve based upon the March 1, 1913, value of the Phelps Dodge Corporation's mines, which reserves were set up under the direction of and in accordance with the regulations of the Treasury Department and made up of the proceeds from the sale of capital assets owned on March 1, 1913.

7. That the court erred in failing and refusing to find that the dividends constituted a return of capital to the stockholders.

8. That the court erred in failing and refusing to find that the directors in each of these years believed they were paying dividends out of the company's net income inasmuch as the depletion was taken on the books of the company at a considerably less amount than that ultimately allowed by the Government on March 2, 1920.

9. That the court erred in refusing to find that the total distributions to the stockholders of the Phelps Dodge Corporation
151 during the years 1913 to 1917, inclusive, exceeded the net income of those years as computed by the Government, by the amount of $1,616,000.00.

10. That the court erred in refusing to find that in no circumstances can Mr. Douglas's share of $1,616,000.00 of the amount distributed as depletion dividends in 1917 be regarded as taxable income accruing subsequent to March 1, 1913.

11. That the court erred in holding and deciding that any part of the dividends that were paid by the Phelps Dodge Corporation in the years 1913, 1914, or 1915, came from the surplus that had accrued, accumulated since March 1, 1913, or the depletion reserve that had been set aside based on the value of March 1, 1913.

12. That the court erred in holding and deciding that distributions to shareholders in the year 1917, are to be regarded as made from current earnings and not the most recently accumulated surplus, set up on the books of Phelps Dodge Corporation, and in failing to find that the Phelps Dodge Corporation 1917 distributions were from the surplus so ascertained and set up as of December 31, 1916.

13. That the court erred in failing and refusing to find that "the most recently accumulated undivided profits or surplus" in section 31–b of the revenue act of 1916 as amended, is limited to such
152 profits and surplus as are definitely ascertained by closing the books.

14. The court erred in finding that Congress did not intend to use the terms "most recently accumulated undivided profits or surplus" in section 31–b of the act of 1916 as amended by the act of 1917, in a strict technical sense which would exclude from their embrace current profits.

15. That the court erred in finding that Congress in the subsequent legislation in the revenue acts of 1918 and 1921 in substituting for the words "most recently accumulated undivided profits or surplus," the word "earnings" in the section corresponding to section 31–b intended not a change but a mere clarification of the law.

16. The court erred in finding that depletion distributions without a corresponding reduction of capital stock are not to be differentiated in the matters here under consideration from ordinary dividends.

17. The court erred in finding that depletion reserve account is a mere bookkeeping account and that any distributions purporting to come therefrom are from the general assets of the company.

18. That the court erred in finding the revenue act of 1916, as amended, correctly interpreted by paragraph 26 of Regulations 33.

19. That the court erred in failing and refusing to find
153 that $147,415.11 of the Phelps Dodge distributions paid to Mr. Douglas in 1917 was a true depletion or capital payment and free from tax.

20. That the court erred in finding that the amounts deducted for depletion from the annual receipts of mining companies are "earnings or profits," as those words are used in section 31–b of the act of 1916 as amended by the act of 1917.

21. That the court erred in failing and refusing to find that sound business principles require that in arriving at "earnings or profits" of wasting industries, depletion be deducted in order to preserve capital intact.

22. That the court erred in failing and refusing to find that the doctrine of Lynch v. Hornby, 247 U. S. 339, does not apply to a specific distribution from a depletion reserve, accrued prior to March 1, 1913, but realized subsequent thereto.

23. That the court erred in failing and refusing to find that such distribution is an extraordinary or liquidating dividend and is a return of capital to the stockholders, tax exempt under the doctrine of Lynch v. Turrish, 247 U. S. 221.

24. That the court erred in failing and refusing to find that under the definition of dividend contained in the act of 1916, section 2–a, and repeated in section 31–a of the act of 1917 limiting such distributions to "earnings or profits accrued since March 1,
154 1913," the two distributions in question are not dividends as defined, but are distributions from depletion reserve and are not taxable income within the law.

25. That the court erred in holding and finding that section 31–b applied to and covered a distribution out of earnings and profits accumulated before March 1, 1913, or increase in value accrued before March 1, 1913, which was, in fact, a distribution of capital assets and in holding that section 31–b, if so construed, was not an attempt to levy a tax on capital without apportionment among the States according to population, according to Article I, section 4 of the Constitution.

26. That the court erred in holding that the word "deemed" in said section 31–b raised an irrebuttable presumption and thereby precluded the taxpayer and the plaintiffs from showing that the distributions in question in this case were in fact made from a capital reserve or fund, and thus gave to the law a construction which made it a direct or capital tax or levy in violation of section 4 of Article I of the Constitution of the United States, as not being apportionment among the States according to population.

27. That the court erred in failing and refusing to find that section 31-b has no application whatever to a distribution out of anything other than a surplus or undivided profits account accumulated out of earnings since March 1, 1913.

155 28. That the court erred in failing and refusing to find that section 31-b does not apply to liquidating distributions from a depletion reserve, by law a fund made up of deductions from receipts before net income was fixed.

29. That the court erred in failing and refusing to find that the word "deemed" as used in 31-b merely raises a rebuttable presumption that 1917 distributions were made from the most recently accumulated undivided profits and surplus.

30. That the court erred in failing and refusing to find that the action of the corporation in this case rebuts the presumption raised by section 31-b and establishes that these dividends were paid out of capital assets.

31. That the court erred in failing and refusing to find that section 31-b is illegal and void in its attempt to penalize the innocent stockholder for the disobedience of the law by the directors of the corporation.

32. That the court erred in failing and refusing to find that section 31-b, if construed retroactively, is unconstitutional and void under the fifth amendment as a denial to the stockholder of due process of law.

33. That the court erred in failing and refusing to find that the capricious and arbitrary classification in section 31-b, making

156 distributions from either the earnings or profits accumulated before March 1, 1913, or from depletion reserve based thereon, prior to "August 6, 1917," free from tax, and such distributions after such date taxable, is unconstitutional under the fifth amendment.

34. That the court erred in failing and refusing to find that the words "most recently accumulated undivided profits or surplus," as used in the act of 1917, section 31-b, refer to the "undivided profits and surplus account" as shown by the books to have accumulated prior to the close of the last fiscal period.

35. That the court erred in failing and refusing to find that the words "most recently accumulated undivided profits or surplus," as used in section 31-b of the revenue act of 1916 as amended by the revenue act of 1917, do not and did not include or refer to the current earnings of the year 1917.

36. That the court erred in entering judgment for the defendant.

37. That the court erred in dismissing the complaint herein upon the merits.

Wherefore, the said plaintiffs pray that the said judgment be reversed and that the said court may be directed to enter a judgment in accordance with the prayer of the bill.

DOUGLAS, ARMITAGE & MCCANN,
Attorneys for the Plaintiffs,
233 Broadway, New York, N. Y.

157 In United States District Court

Stipulation for supersedeas bond

[Title omitted.]

It is stipulated and agreed by and between the attorneys for the respective parties hereto that the amount of cost and supersedeas bond of the plaintiffs above named on the writ of error herein to the United States Circuit Court of Appeals for the Second Circuit be fixed at two hundred and fifty ($250) dollars and that an order may be entered hereon in accordance herewith, without further notice to either party as against the other.

Dated, May 15, 1923.

DOUGLAS, ARMITAGE & MCCANN,
Attorneys for Plaintiffs.

WM. HAYWARD,
U. S. Attorney, Attorney for Defendant.

(A supersedeas bond by Archibald Douglas, George Notman, and Edmund Coffin, as executors of the estate of James Douglas, deceased, as principals, and the Maryland Casualty Company, as surety, in the sum of two hundred and fifty ($250) dollars, approved by Hon. Henry W. Goddard, United States district judge, was duly filed on May 15, 1923.)

158 [Citation in usual form omitted in printing.]

159 In United States Circuit Court of Appeals

Order extending time

[Title omitted.]

Upon the annexed affidavit of Edward Holloway, verified the 12th day of June, 1923, and the annexed consent of William Hayward, U. S. attorney, attorney for the defendant in error,

Now, on motion of Douglas, Armitage & McCann, attorneys for the plaintiffs in error, it is

Ordered that the time of the plaintiffs in error within which to docket case and file the record be, and the same hereby is, extended to and including the 15th day of July, 1923.

JULIAN W. MACK,
Judge, U. S. Circuit Court of Appeals.

160 In United States District Court

Stipulation re transcript of record

[Title omitted.]

It is hereby stipulated that the foregoing and all of the same is a true transcript of the record in the above-entitled cause and that the same may be so certified by the clerk and filed herein.

Dated New York, July 14, 1923.

DOUGLAS, ARMITAGE & MCCANN,
Attorneys for Plaintiffs.

WM. HAYWARD,
U. S. Attorney, Attorney for Defendant.

161 In United States District Court

Clerk's certificate

[Title omitted.]

I, Alexander Gilchrist, jr., clerk of the District Court of the United States of America for the Southern District of New York, do hereby certify that the foregoing is a correct transcript of the record of the said District Court in the above-entitled matter as agreed on by the parties.

In testimony whereof, I have caused the seal of the said court to be hereunto affixed at the city of New York, in the Southern District of New York, this ——— day of ———, in the year of Our Lord one thousand nine hundred and twenty-three, and of the independence of the United States the one hundred and forty-eighth.

ALEXANDER GILCHRIST, JR., *Clerk.*

162 In United States Circuit Court of Appeals for the Second Circuit

No. 95—October term, 1923

Argued November 15, 1923. Decided April 7, 1924.

ARCHIBALD DOUGLAS, GEORGE NOTMAN AND Edmund Coffin, as Executors of the Estate of James Douglas, deceased, plaintiffs-in-error (plaintiffs below) v. WILLIAM H. EDWARDS, COLLECTOR OF UNITED States internal revenue for the second district of the State of New York, defendant-in-error (defendant below)	In error to the District Court of the United States for the Southern District of New York

Before Rogers, Manton and Mayer, circuit judges.

Opinion

Writ of error to a judgment of the District Court for the Southern District of New York entered on a directed verdict in favor of defendant, dismissing the complaint and awarding costs against plaintiffs to defendant.

The facts having been stipulated, only questions of law were in controversy and each side, therefore, moved for the direction of a verdict with the result supra.

The action was brought to recover $173,579.72 additional income tax for 1917, paid under protest by plaintiffs to defendant collector.

163 A claim for refund was duly made and denied.

The additional tax was levied on two-called depletion distributions made in September and December, 1917, by Phelps, Dodge

Corporation, a mining company and received in his lifetime by James Douglas, a stockholder.

It is contended by plaintiffs that these dividends were not income and, therefore, not taxable or, if income and taxable, then not at the 1917 rate, while defendant insists that the dividends were taxable as income and at the 1917 rate.

Phelps, Dodge & Co., Inc., was organized under the laws of New York on December 14, 1908, with an authorized capital stock of $50,000,000, divided into 500,000 shares of the par value of $100 each. $45,000,000 par value was issued for $90,000,000 of assets of which $66,000,000 represented copper and coal mines and $24,000,000 other assets.

The corporation thus had a capital stock of $45,000,000 and a paid-in surplus of $45,000,000.

These assets were held by various subsidiary companies but the history and relation of these companies need not be recited as the parties agree that these antecedent details do not affect the controversy.

By March 1, 1913, the assets of the corporation had increased in value to $153,275,606.69 of which $132,285,000 represented the value of its mines and the balance represented the plant investments and other current assets.

On March 1, 1913, Douglas held 41,025 shares of the capital stock of Phelps, Dodge & Co. Inc.; on July 2, 1913, he purchased 25 additional shares of such stock. He held this stock until April 1, 1917, when in the reorganization infra he exchanged his 41,050 shares in Phelps, Dodge & Co., Inc., for 41,050 shares in Phelps, Dodge Corporation, which shares he held continuously until his death on June 25, 1918.

164 On April 1, 1917, the business was reorganized in a manner not material to the issues here involved, and Phelps, Dodge Corporation (hereinafter called Phelps Co.), became the name of the reorganized company and became the parent company. For brevity and convenience, Phelps Co. will be understood to refer to the present and previous corporations.

From 1913 to 1917, inclusive, the mines owned by Phelps Co. were operated and the product sold and in each year a certain amount was deducted from gross income and credited on the books of the company to a depletion reserve account to make good the wastage caused by the operation of the mines.

In 1918, Phelps Co. filed its income and excess profits tax returns for the year 1917.

On December 1, 1919, the Commissioner of Internal Revenue made a provisional valuation for depletion and other purposes of the various mining properties owned as of March 1, 1913. It was held that Phelps Co. had an outstanding capital stock of $45,000,000, a paid-in surplus of $45,000,000, and the "total value fixed by the bureau as of March 1, 1913" of all the company's mines was $132,285,000.

Upon the basis of the foregoing valuation the income and excess profits tax returns of Phelps Co. for the years 1917 and 1918 were audited and closed by the Commissioner of Internal Revenue and the tax paid.

These taxes of the corporation were adjusted to make them correspond with the revised depletion figures. Phelps Co. had set up on its books a depletion reserve from 1913 to 1917, inclusive, which for these years aggregated $14,416,783.88. This depletion reserve was revised by the Commissioner of Internal Revenue and increased for this period to $25,837,427.91. The summary memorandum of the changes in financial conditions of Phelps Co. from 1912 to 1917 is noted in the margin for convenient reference.

165 [Plaintiff's Exhibit D. Phelps Dodge Corporation memorandum re changes in financial condition, 1912–1917, omitted. Printed side page 32p ante.]

166 In 1913 after deducting the depletion fixed by the Commissioner of Internal Revenue, Phelps Co. earned a net profit of $6,373,116.86. Total distributions to stockholders in 1917 aggregated $7,425,000 or $1,051,883.14 more than its net profit. Obviously, this excess must have been paid out of surplus which it had on hand at the beginning of the year, i. e., surplus accumulated prior to March 1, 1913, since there was no other fund from which it could have been paid. The result was that the surplus at the end of 1913 decreased from $108,275,606.79 to $107,223,723.55 or by $1,050,883.14, the exact amount by which the distributions paid to stockholders exceeded the profits.

By following Exhibit D, it will be noted that by the end of 1915, Phelps Co. had paid out of its profits since March 1, 1913, and in addition, out of surplus accumulated prior to that date, a sum aggregating $7,084,901.15, the amount by which the distributions paid in 1913, 1914, and 1915 exceeded the amount of profits earned in those years.

In 1916, the situation changed. In that year, the company earned a net profit of $17,750,621.67 over its depletion deduction and paid dividends amounting to $14,625,000. It, therefore, had an excess of profits over dividends of $3,125,621.67.

In 1917, the company earned net profits of $16,742,487.06 and paid regular dividends of $10,800,000. At a meeting of the board of directors of the company, on September 13, 1917, the company passed a resolution which recited that it had yearly in computing its income deducted therefrom a reasonable allowance for depletion of its mines based upon the fair market value thereof as of March 1, 1913, and that the statutes and department rulings provided for a separation of these deductions from income and that payments to stockholders from the depletion account would be a return of capital invested and not subject to income tax in the hands of the shareholders and thereupon it resolved:

167 "That this company distribute among its stockholders from said depletion account, three dollars a share, to be paid

on September 28, 1917, to stockholders of record on September 24, 1917, the total amount so paid to be deducted from said depletion account."

In December, 1917, a similar resolution was passed, this time, however, distributing $5.00 per share to the stockholders.

The total distribution of these so-called depletion dividends aggregated $3,600,000 and the amounts received by Douglas were, respectively, $123,150 and $205,250, or a total of $328,400.

The return of Phelps Co. for the year 1917 was audited on or about March 2, 1920, and the 1917 income and excess profit taxes of Phelps Co. were finally determined on or about that date.

Douglas in his 1917 income tax return included in his taxable income all dividends received from Phelps Co. except the two so-called depletion dividends of September 28th and December 28th, 1917. He inserted, however, in making up his return a note showing the receipt of these so-called depletion dividends. It was upon this sum of $328,400 that the Commissioner of Internal Revenue assessed an additional income tax and this was the additional income tax paid to defendant by the executors of Douglas on May 16, 1919, which is the subject matter of this controversy. It will also be observed that the income for 1917 before deducting depletion was $22,456,906.32. After deducting the sum of $5,714,419.26, the amount of depletion at Treasury Department rates, the remainder upon that basis representing the earnings or profits for 1917 was the sum of $16,742,487.06. Adding together the total of dividends stated in Exhibit D to have been paid from earned surplus, i. e., $10,800,000 to the sum of $3,600,000, being the amount of so-called depletion distributions; the total is $14,400,000. Deducting this
168 last named amount from the sum of $16,742,487.06 supra, there still remained a balance of 1917 earnings of $2,342,487.06.

Certain amounts were set up by the corporation on its books contemporaneously with the declaration and payment of the so-called depletion dividends and various entries made.

The statute particularly requiring construction reads as follows:

"SEC. 31 (a). That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, * * * out of its *earnings or profits accrued since March first, nineteen hundred and thirteen*, and payable to its shareholders, whether in cash or in stock of the corporation, * * * which stock dividend shall be considered income, to the amount of the *earnings or profits* so distributed.

SEC. 31 (b). Any distribution made to the shareholders or members of a corporation, * * * in the year nineteen hundred and seventeen, or subsequent tax years, *shall be deemed* to have been made from the *most recently accumulated undivided profits or surplus*, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which

such profits or surplus *were accumulated* by the corporation * * * but nothing herein shall be construed as taxing any *earnings or profits accrued prior to* March first, nineteen hundred and thirteen, but *such earnings or profits* may be distributed in stock dividends or otherwise, exempt from the tax, *after* the distribution of *earnings and profits accrued since* March first, nineteen hundred and thirteen has been made. This subdivision shall not apply to
169 any distribution made prior to August sixth, nineteen hundred and seventeen, out of *earnings or profits accrued* prior to March first, nineteen hundred and thirteen." (40 Stat. L., 337, 338. Italics ours.)

Douglas, Armitage & McCann (Matthew C. Fleming, Archibald Douglas, Paul Armitage, and Edward Holloway, of counsel), for plaintiffs in error. William Hayward, United States attorney (Richard S. Holmes, special asst. U. S. attorney, of counsel), for defendant in error. George E. Holmes (Randolph E. Paul and Donald Havens, of counsel), amicus curiae.

MAYER, circuit judge: We have not considered it necessary to set forth the details of various entries and accounts as they were made and carried on the books of Phelps Co. and in respect of which counsel have presented various arguments.

There is no question of good faith in regard to these entries; but it is well at the outset to realize that, in this case, the rights of the parties can neither be established nor impaired by the bookkeeping methods employed or by the names given to the various items. Whether something is capital or income and to what year dividends should be allocated depends partly upon the subject matter and partly upon the statute involved when construed in the light of constitutional requirements.

1. The first contention is that the two so-called depletion distributions were of capital to the stockholders and hence not taxable under the sixteenth amendment of the Constitution of the United States.

170 On March 1, 1913, Douglas owned 41,025 shares of Phelps Co. On July 2, 1913, he acquired 25 more shares. These 41,050 shares he owned in 1917 when he received his proportion upon the distribution of the so-called depletion dividends.

Plaintiffs insist that the fund set aside from time to time for the depletion reserve was capital. There is no controversy as to the various amounts under this head set forth in plaintiff's Exhibit D because they are not mere arbitrary entries by Phelps Co.; but they have been audited and determined by the appropriate department of the Government.

The assertion of plaintiffs, briefly stated, is that the two depletion distributions were a partial realization of an investment made by Douglas years prior to 1917 and represented the gradual increase which had arisen before the effective date of the sixteenth amendment and thus were not taxable as income, gains, or profits. De-

fendant necessarily concedes that, if these distributions were a return of capital, then they were not income of the stockholder Douglas and hence not taxable. Counsel have indulged in arguments somewhat elaborate and have sought to fortify them by references to books on accounting and discussions in respect of the distinctions between capital and income. We need not, however, be led into these controversial paths; for the determination of this question rests upon the understanding of two cases decided by the Supreme Court of the United States, argued at the same time and decided on the same day.

In Lynch v. Turrish, 247 U. S. 221, there was a complete liquidation and winding up. The property of the corporation there concerned had increased in market value with the result that the market value of its shares had increased to twice par value by March 1, 1913. Later, the company sold all its property and made final distribution of the proceeds to the shareholders on surrender of
171 their certificates of stock. The amount thus received by each shareholder was twice the par value of his shares; but represented no increase since the effective date of the act of October 3, 1913, 38 Stat., 166. The Supreme Court held that the value thus received was not "income, gains or profits" of the shareholders subject to the tax.

In Lynch v. Hornby, 247 U. S. 339, it appeared that Hornby from 1906 to 1915 was the owner of 434 shares of the capital stock of a lumber company. On or prior to March 1, 1913, owing to the increase in value of the timber lands of this company and through its business operations, the property had greatly increased in value and Hornby's stock had become worth nearly four times its par value. In 1914, the company distributed dividends aggregating $650,000, of which $240,000, or 24 % of the par value of the capital stock was derived from current earnings and $410,000 from conversion into money of property that it owned or in which it had an interest on March 1, 1913. Hornby's share of the latter amount was $17,794, and this was the amount which was the subject matter of the suit.

Mr. Justice Pitney, writing for the court, definitely distinguished the case from the Turrish case, supra, calling attention to the fact that in the latter case there was a single and final dividend received by Turrish in liquidation of the entire assets of the business of the company of which he was a shareholder and thus a return to him of the value of his stock upon the surrender of his entire interest in the company at a price which represented its intrinsic value at and before March 1, 1913, when the then income tax took effect.

In the Hornby case, there was no winding up or liquidation nor any surrender of Hornby's stock. The court pointed out the difference between a stockholder's undivided share in the profits of a corporation prior to the declaration of a dividend and his participation in the dividends declared and paid, as follows:

172 "It is evident that Congress intended to draw and did draw a distinction between a stockholder's undivided share

or interest in the gains and profits of a corporation, prior to the declaration of a dividend, and his participation in the dividends declared and paid; treating the latter, in ordinary circumstances, as a part of his income for the purposes of the surtax, and not regarding the former as taxable income unless fraudulently accumulated for the purpose of evading the tax. * * *

The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him ab extra, and as constituting a part of his income when they come to hand."

In concluding the opinion the court said: "Lynch v. Turrish and Southern Pacific C. v. Lowe, rest upon their special facts and are plainly distinguishable." Prior to and after the Turrish and Hornby cases, the Supreme Court had occasion to consider, upon other facts and other provisions of statute law, what was capital and what taxable income and in what respects there were certain distinctions between a corporation and its stockholders. Some of these cases were Collector v. Hubbard, 12 Wall. 1; Bailey v. Railroad Company, 22 Wall. 604 and also 106 U. S. 109; Gray v. Darlington, 15 Wall. 63; Merchants' L. & T. Co. v. Smietanka, 255 U. S. 509; Eldorado Coal Co. v. Mager, 255 U. S. 522; Walsh v. Brewster, 255 U. S. 536. See also opinion of Lowell, D. J., in Merchant's Ins. Co. v. McCartney, 17 Fed. Cas., 46, a case arising out of the act of June 30, 1864, 13 Stat. L., 281.

After examination of these and other cases, we are unable to distinguish the case at bar from the Hornby case. Much is made by plaintiffs in error of expressions used in the Hornby case, to
173 the effect that the dividends in question were "received in the ordinary course by a stockholder from a corporation" and were declared and paid "in the ordinary course of business." As we read the Hornby case, these expressions were clearly explained by the context, for the court said that though these dividends were extraordinary in amount and "might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing"; yet they were taxable. The court also, in using the expression as to "ordinary course of business" was plainly distinguishing the Hornby case from other cases some of which were contemporaneously decided where there was a different situation than the mere declaration of a dividend or analagous distribution. In the Turrish case, as has been stated, there was a final liquidation. In Southern Pacific Co. v. Lowe, 247 U. S. 330, there was, inter alia, a question of real as contrasted with technical ownership. In Peabody v. Eisner, 247 U. S. 347, the question was whether a dividend by a corporation of shares owned by it in another corporation was a stock dividend.

On this branch of the case at bar, therefore, we think the question argued is ruled by authority and, for that reason, further discussion seems unnecessary.

2. The question which arises under section 31(b) of the act of 1917, passed October 3, 1917, is whether Douglas should have been taxed at the 1917 rate or at the rate prevailing in some year prior to 1917. The controversy revolves around the meaning of the expression "most recently accumulated undivided profits or surplus." There is also a difference of opinion as to the meaning of the word "deemed."

We may dispose at the outset of the meaning of "deemed." If it had been intended that this word should mean a rebuttable and not a conclusive presumption, the word "presumed" could
174 readily have been used and that is a word which is very familiar in many statutes. "Deemed" and its synonym "regarded," according to definitions in cases and dictionaries is the equivalent of "considered" or "adjudged." Leonard v. Grant, 5 F. R. 11, 16; U. S. v. Doherty, 27 F. R. 730, 734; Michel v. Nunn, 101 F. R. 423; Cardinary v. Smith, 5 Fed. Cas. 45, 47; Walton v. Cavin, 16 Q. B. 48, 81.

We think it was the purpose of the statute that any distribution made to shareholders should be conclusively presumed to have been made from the most recently accumulated undivided profits or surplus and that it was intended that the corporation should not be permitted to determine to what year or period or to what fund it would allocate such distribution. Any other construction might well have led to confusion and inequalities.

Defendant-in-error contends that the statute means that, if a distribution was made on or after August 6, 1917, during the year 1917 and if the amount thus distributed was equal to or exceeded the current earnings for the year 1917, then the taxpayer-stockholder was taxable at the 1917 rate. Plaintiffs-in-error contend, on the contrary, that the statute did not refer to current earnings but to undivided profits or surplus accumulated in some year prior to 1917 and in the year wherein such undivided profits or surplus had most recently been accumulated.

An examination of sections 31 (a) and 31 (b) at once discloses that the Congress used the words "earnings or profits" six times whereas when referring to the rates applicable to the distributee it used entirely different phraseology, i. e., "most recently accumulated undivided profits or surplus" and "for the years in which such profits or surplus were accumulated."

It can not be assumed that these words were used carelessly
175 nor can the statute be approached with the presumption that the Congress intended that this phraseology should be equivalent to that which would express current earnings or profits. The time-worn observation may be indulged in that, if the Congress had intended to say "earnings or profits" as referring to current earnings, is could readily have done so by using these words so long familiar in taxing statutes. The language used in a taxing statute is always a matter of prime importance and the rule has recently again been stated in United States v. Merriam, 263 U. S. 179, 41

Sup. Ct. 69, 71, 72. In that case, Mr. Justice Sutherland, speaking for the court said:

"On behalf of the Government it is urged that taxation is a practical matter and concerns itself with the substance of the thing upon which the tax is imposed rather than with legal forms or expressions. But in statutes levying taxes the literal meaning of the words employed is most important, for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer. Gould v. Gould, 245 U. S. 151, 153, 38 Sup. Ct. 53, 62 L. Ed., 211. The rule is stated by Lord Cairns in Partington v. Attorney General, L. R. 4 H. L. 100, 122:

"'I am not at all sure that, in a case of this kind—a fiscal case—form is not amply sufficient; because, as I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, can not bring the subject within the letter of the law, the subject is free, however
176 apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.'

"And see Eidman v. Martinez, 184 U. S. 578, 583, 22 Sup. Ct. 515, 46 L. Ed., 697."

The cases, like Bank of Commerce v. Tennessee, 161 U. S. 134, 146, and Cornell v. Coyne, 192 U. S. 418, 431, in which the doubt is resolved in favor of the Government and against the taxpayer are those in which the taxpayer claims an exemption or a privilege.

That is not this case. Here, so far as concerns, in this regard, the construction of section 31(b), plaintiffs do not ask for an exemption or privilege; on the contrary, they assert that, as matter of right under the statute, the deceased shareholder should have been taxed at other than the 1917 rate.

It is an accepted principle that for purposes of statutory construction, within certain limits, resort may be had to subsequent statutes. United States v. Field, 255 U. S. 257; Smietanka v. First Trust & Savings Bk., 257 U. S. 602; Schwab v. Doyle, 258 U. S. 529; Monroe Cider, Vinegar & Fruit Co. v. Riordan, 280 F. R. 624; Irwin v. Gavit, 2nd Circuit, C. C. A., decided Dec. 10, 1923.

Availing of this principle, the parties each seek comfort in the revenue act of 1918. Defendant urges that the omission in
177 the revenue act of 1918 of the words "undivided profits or surplus" and the use of the words "earnings or profits," as applied to accumulations clarified section 31(b) of the revenue act of 1917. We agree that there was clarification, but not of the kind

urged by defendant, unless "undivided profits or surplus," as used in the statute of 1917 meant the same thing as current earnings or profits. We realize that the definition of "surplus" and "undivided profits" may be of some importance, but the real emphasis should be upon the expression "most recently accumulated undivided profits or surplus" and to this we shall refer infra.

In section 201(b) of the revenue act of 1918, it is provided, *inter alia*, "Any distribution shall be deemed to have been made from *earnings* or *profits* unless all *earnings* and *profits* have been distributed. Any distribution made in the year 1918 * * * shall be deemed to have been made from *earnings* or *profits* accumulated since February 28, 1913." (Italics ours.)

In section 201(d) of the same act, it is provided, *inter alia*, that dividends to shareholders "shall * * * be taxed to the recipient at the rates prescribed by law for the years in which the corporation accumulated the *earnings* or *profits* from which such dividend was paid, but the dividend shall be deemed to have been paid from the *most recently accumulated earnings or profits*." (Italics ours.)

Then follows, perhaps, the most significant provision of section 201 of the act of 1918, i. e., subdivision (e), because this subdivision removes any doubt in that act as to what is meant by "accumulated earnings or profits" and lays down a new and perfectly clear method of prorating. This subdivision (e) reads as follows:

"Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earn-
178 ings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period."

In this 1918 act it is apparent that the Congress, for reasons deemed wise, enacted a plain rule of taxation whereby it laid hold of current earnings as the basis of the tax, allocated any distribution made during the first sixty days of any taxable year to earnings or profits accumulated during preceding taxable years and, inter alia, set up a rule of proportionate distribution to cover distributions, made as in the case at bar, intermediate the end of the first sixty days of the year (approximately March 1st) and the date of distribution, to the extent of such earnings or profits, as might have been accumulated between the close of the preceding taxable year and the date of distribution. This same provision was repeated and again enacted in section 201(e) of the act of 1921.

Notwithstanding that in these two subsequent acts the Congress found it necessary not only specifically to set forth a rule of taxation

but to use different language from what it had employed in the 1917 act, defendant here is seeking to apply the provisions of section 201, particularly of subdivision (e) of the 1918 act to the facts in the case at bar upon the insistent argument that "most recently accumulated earnings or profits," as used in the 1918 act, meant precisely the same as "most recently accumulated undi-
179 vided profits or surplus," as used in the 1917 act; and defendant to press the argument has been compelled to devise somewhat elaborate tables to show the financial status of Phelps Co. at the date of distributions in September and December, 1917.

In section 201(a)(3) of the 1917 act, relating to the war excess profits tax and defining "invested capital," reference is made to "paid-in or earned surplus and undivided profits earned during the taxable year." The subject matter of this section is entirely different from that of the statute here under consideration and, if any argument is to be rested thereon, it would be that, in 1917, the legislature demonstrated its intent to exclude undivided profits contemporaneously earned, i. e., during the current taxable year.

It is a well-established rule of statutory construction that, if technical words are used in a statute in reference to a subject matter as to which they have acquired a technical meaning, they are to be taken in a technical sense. 36 Cyc. 118 and cases cited.

Coming then to the meaning of "surplus" and "accumulated surplus," it will be found that these words have been defined or interpreted on many occasions in connection with the consideration of some particular statute. Leather Manufacturers Nat. Bk. v. Treat (U. S.), 116 F. R. 774; Anderson v. Farmers' Loan & Trust Co., 241 F. R. 322; McConnell v. Allen, 120 App. Div. 548; Mutual Ben. Life Ins. Co. v. Utter, 34 N. J. Law (5 Vroom), 489, 491; People's Fire Ins. Co. v. Parker, 34 N. J. Law (5 Vroom), 479,
482; People's Fire Ins. Co. v. Parker, 35 N. J. Law (6
180 Vroom), 575, 577; Trenton Iron Co. v. Yard, 42 N. J. Law (13 Vroom), 357, 359; Goodnow v. American Writing Paper Co., 73 N. J. Eq. 692; Mills v. Britton, 29 Atl., 231, 236, 64 Conn. 4, 24 L. R. A. 536; Equitable Guarantee & Trust Co. v. Rogers, 44 Atl. 789, 793, 7 Del. Ch. 398; Hunter v. Hersperger, 54 Atl. 65, 67, 96 Md. 292; Towery v. McGaw (Ky.), 56 S. W. 727, 728.

"Surplus" has also been the subject matter of construction in cases, inter alia, involving insurance policies and decedents' estates.

Books and essays on accounting of which many are referred to by counsel define and explain in accordance with the view of the particular author the meaning of "surplus," "surplus earnings," "surplus account," and similar expressions.

Thus, it is that general definitions will be found which may be accurate for the purposes of the discussion of a particular subject matter by a court or text book writer or essayist, but which may not be applicable to some other case. The case at bar does not call for an academic discussion of accounting or bookkeeping methods nor for a comparison of definitions found in adjudicated cases.

Two simple definitions readily understood and not embarassed by any abstruse complication may be found in cases in this circuit. In Leather Manufacturer's Nat. Bk. v. Treat, 116 F. R. 774, Judge Lacombe, in discussing a provision of the war revenue act of 1898, 30 Stat., 448, affecting bankers, said, "It would seem rather that Congress used the words 'surplus' in its ordinary sense, as indicating the amount left after setting aside sufficient of the assets of a banker to meet his liabilities."

181 Judge Augustus N. Hand, in Anderson v. Farmers' Loan & Trust Co., 241 F. R. 322, speaking for this court, in referring to the words "capital, surplus, and undivided profits," used in the statute there under consideration, said that these words related "to no particular kind of property, but are expressions describing the amount of residue of the assets after the liabilities have been deducted."

For the purposes of this case, either definition supra will do.

The expression "undivided profits" is for all practical purposes of this statute synonymous with "surplus" and certainly with "accumulated surplus." It means such profits as exist and have or have not been ascertained, but, in any event, have not been distributed or otherwise used and is distinguishable from current earnings or profits.

It is matter of common knowledge and, indeed, an obvious fact that accumulated undivided profits or surplus can not be ascertained without investigation or some appropriate method of accounting or calculation. The ordinary methods of corporate accounting in this regard have been recognized by the Supreme Court. Thus, in Eisner v. Macomber, 252 U. S. 189 at 209, Mr. Justice Pitney said:

"For bookkeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a 'capital stock account.' If profits have been made and not divided they create additional bookkeeping liabilities under the head of 'profit and loss,' 'undivided profits,' 'surplus account,' or the like";

and Mr. Justice Brandeis, in his dissenting opinion, used, in the course of his discussion, language and illustrations familiar in usual corporate accounting and bookkeeping methods.

182 A corporation does not ordinarily set up on its books in the intermediate course of a year the amount of its accumulated surplus or undivided profits. It is manifestly impracticable from month to month to take inventories or compile data to ascertain what surplus or undivided profits have been accumulated for a fraction of a current year. Accumulated surplus or undivided profits are ordinarily ascertained at the end of a given calendar or fiscal year. What are the true accumulated undivided profits or what is the true accumulated surplus is always a question of fact and, under a revenue statute, that question of fact is usually determined by the appropriate bureaus of the Treasury Department

subject to such review as may be provided by statute. A person or a corporation really does not know what are the profits of his or its business until the conclusion of some fixed period, whether it be a calendar or fiscal year. If a corporation on February 1st of any year were to distribute in dividends profits made in the January immediately preceding, it might find that all these profits would, for one reason or another, be wiped out in March of the same year. If, on the other hand, the "undivided profits or surplus" accumulated in January were not distributed, it would be a misnomer to say that on February 1st of the same year there was on hand accumulated undivided profits or surplus for the month of January. In literal language, that might be true, because the undivided profits or surplus of January would have been accumulated in the sense that they had not been distributed. In taxing statutes, however, as in most other matters regulated by law, we do not deal in abstractions; and an income tax statute usually provides for fixed periods as the measure of calculation and obligation and this is because business, large and small, is done that way and no man in active business can tell where he stands financially for a given time, whether it be a calendar year or fiscal year or some other definite period until he shall have arrived at the end of that period
183 and is then able on facts known or ascertainable to determine, with reasonable approach to accuracy, what is his financial condition.

Section 201(e) of the 1918 act recognized all this and strikingly so in respect of the first sixty days. The Congress must have realized that dividends declared during January and February would ordinarily be declared out of the accumulated undivided profits or surplus of a preceding year. The legislature also recognized that a corporation declaring a dividend in any particular year would ordinarily declare it out of the surplus or undivided profits accumulated in some previous year and, therefore, in section 201(e) created a rule of taxation based on a system of accounting and dividend distribution not common in ordinary corporate business.

In 1918, the Congress had the benefit of the experience of 1917 and, indeed, of the whole of the year 1918 (because the act of 1918 did not become law until February 24, 1919) and found it necessary to apply, in some respects, more drastic taxation requirements. Under the Act of 1917, however, the sole preferred class comprised those corporations which prior to August 6, 1917, had made distributions out of earnings or profits accrued prior to March 1, 1913. A corporation which had made its distribution on February 1, 1917, and which had earnings or profits which had accrued subsequent to March 1, 1913, was precisely in the same situation as a corporation which made its distribution on December 31, 1917, in like circumstances.

Yet, if the contention of the defendant were to prevail, it would lead to the conclusion that the Congress in 1917 meant to apply the

1917 rate to the share holder who received a dividend from the corporation making a distribution on February 1, 1917, notwithstanding that, in similar circumstances, the rates of preceding taxable years and not of the current year were applicable under section 201(e) of the act of 1918 where the corporation made its distribution on February 1, 1918.

184 Various arguments are advanced by each side as to the reason for the legislation contained in section 31(b) of the 1917 act. Plaintiffs contend, inter alia, that this legislation was intended to release to shareholders for investment in Liberty bonds and other war purposes sums which had been accumulated by the corporations prior to January 1, 1917. Defendant contends, inter alia, that, because of war needs, the conclusion is irresistible that the shareholders were to be taxed at the rates of the 1917 act which had increased greatly over those of the 1916 and 1913 acts. We can not, however, indulge in speculation as to all the reasons which actuated the Congress in enacting a particular statute. We must find solution by applying the usual relevant principles of statutory construction.

Under the act of October 3, 1913, all dividends distributed after March 1, 1913, were taxable whether the profits out of which such dividends were declared were accumulated before or after that date. Although the World War had begun and economic conditions had been disturbed, the revenue act of 1916 permitted the declarations of dividends out of surplus accumulated prior to March 1, 1913, tax free, even though profits earned subsequent to March 1, 1913, remained undistributed. This history throws some light on the controversy because, under section 31(b) of the 1917 act, while profits accumulated prior to March 1, 1913, could still be distributed tax free, that tax-free distribution could be availed of only after distribution of earnings and profits accrued since March 1, 1913, had been made.

It was in regard to this feature that the Senate committee on October 2, 1917, said in its report, submitted to the Senate after conference with the House of Representatives,

"In order to be just to the corporations and at the same time
185 to encourage them to distribute their annual earnings, your committee reported to the Senate and the Senate adopted an amendment providing that the surplus when distributed shall be taxed to the distributee at the rate prescribed by law for the year in which they were earned, but also provided that any distributions of surplus made in 1917 or subsequent tax years should be deemed to have been made from the most recently accumulated undivided profits, thereby making it necessary for the corporation to distribute its surplus earned since March 1, 1913, before that earned prior to that time." (Cong. Rec., page 8690.)

There is no suggestion in this report that "most recently accumulated surplus or undivided profits" was intended to refer to 1917. On the contrary, the observation as to encouraging corporations to

distribute "their annual earnings" indicated a clear understanding that accumulated "undivided profits or surplus" are ascertained upon some annual basis; and the committee was distinguishing between surplus accumulated before March 1, 1913, and surplus accumulated after that date.

The legislation as originally passed by the Senate read:

"Provided further, That any distribution made to the shareholders of a corporation, joint stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made *from the net income of the years in which such distribution is made or, if such income is insufficient*, from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the shareholder of the respective years in which earned by the corporation, joint stock company, or association, or insurance company, and shall be taxed to the shareholder at the rate prescribed by law for such year."

186 This had been preceded by the report made by Senator Simmons, chairman of the Senate Finance Committee, wherein it was stated, inter alia.

"Ninth, That dividends declared and paid in the year 1917, or subsequent tax years, shall be deemed to have been paid from the *net income of the year in which paid, or from the most recently accumulated surplus*, and shall constitute a part of the annual income of the shareholder for the years in which earned by the concern, and the tax to be paid by the shareholder thereon shall be at the rate prescribed by law for such years." (Report No. 103, 65th Congress, 1st session, Calendar No. 106, p. 21.)

While the Senate Finance Committee and the Senate intended that dividends declared in 1917 should be deemed to have been paid first from such net income as might be earned in 1917, it is plain that this program was not satisfactory to the Conference Committee. The result was that the part of the bill italicized supra, as passed by the Senate, was stricken out and 31(b) was enacted in its present form.

It is argued by defendant that the reason for this elision was that the technical meaning of "net income," under an income tax statute, is by no means synonymous with net earnings because a taxpayer is allowed certain exemptions and the like before his net income can be ascertained.

We think this argument is not convincing; for before the net income of a year can be determined the net earnings must first be ascertained. The real point of this legislative history is that the legislature was not, in this regard, dealing with current earnings and, by the most obvious procedure, had eliminated current earnings from consideration as affecting the rate at which the taxpayer was to be taxed.

187 Of all the other contentions we notice but one. The illustration is suggested of a corporation which had no surplus on

December 31, 1916, or prior thereto and which made earnings, large or small, during the year 1917, and the question is asked whether such earnings would go tax free. Experience demonstrates that, however carefully, a tax statute rarely, if ever, can be drawn with such extraordinary foresight that it will provide for every possibility. Two answers may be suggested to the inquiry: First, if the 1917 statute had continued on the books, any undivided profits or surplus accumulated in 1917 could have been reached in 1918; second, just as shareholders of those corporations which made a distribution prior to August 6, 1917, were in some respects preferentially treated, so it might be well contended that the shareholders in those corporations which might distribute subsequent to August 6, 1917, out of undivided profits or surplus accumulated prior to 1917 were to be preferentially treated over those who received dividends out of profits made solely in 1917. There is support for the latter view in conditions that were then and are now well known. The war appreciated the value of certain classes of business and destroyed or impaired the value of others. New business enterprises were started to manufacture and sell munitions and other products to which the war had given unprecedented values. It was but right that those who benefited should make substantial contributions to the Government. Upon the other hand, many corporations, at the close of 1916, had on hand accumulated surplus or undivided profits which had not been distributed. The shareholders of such corporations had, in effect, no power to compel distribution; for, in the absence of fraud, declaration of dividends and the distribution of accumulated surplus and profits rested in the discretion of the directors of the corporations.

188 It may well be concluded, as indicated by the report of the Senate committee, after conference, that it was regarded as fair that the shareholder, who had invested his money in a corporation which on December 31, 1916, or prior thereto, had accumulated undivided profits or surplus undistributed, should not be asked to pay the high 1917 rate, if dividends could be distributed out of previously accumulated undivided profits or surplus. But, if any or all these suggestions are without merit, it is nevertheless clear, as matter of statutory construction, that it was not intended, on facts such as those in the case at bar, that the shareholder should be taxed at the 1917 rate, even though, because of the amount involved, "it requires a struggle to resist the influence of the fact," as was tersely said by Mr. Justice McKenna, in Lynch v. Turrish, supra.

We have not overlooked the Treasury regulation (article 107 of Regulations 33, revised), which interpreted the statute substantially as defendant contends. We are also mindful of the rule that the regulations and practices of administrative departments are entitled to weight and serious consideration in construing a statute; but opposed to this rule is the familiar one that it is for the courts to construe a statute and not the executive departments of the Govern-

ment and, where, as here, we are satisfied that the statute requires the construction which we have attributed to it, a Treasury regulation rises to no higher dignity than an expression of opinion.

We have also not overlooked the fact that Douglas paid at the 1917 rates on the so-called regular dividends, but, as this payment was not in issue in this litigation, we express no opinion as to what might be the correct rule if Douglas had insisted that his so-called regular dividends were not subject to the 1917 rate.

We have also noted the observation passim of counsel for defendant that the complaint stresses the proposition that the
189 so-called depletion dividends were capital and not income and that it is not, in so many words, alleged that Douglas is not subject to the 1917 rate. We think, however, that the language, both of the protest and of the complaint, is sufficiently broad to put the question in issue and the record clearly indicates that the parties litigated this question as well as the capital-income question and so desired and understood.

In view of our conclusion that the so-called depletion dividends were taxable, there was on hand on December 31, 1916, a sum amply sufficient to enable Phelps Co. to pay these dividends out of the accumulated surplus or undivided profits as of December 31, 1916; and these dividends distributed to and received by Douglas should have been taxed at the rate prevailing in 1916.

Under Slocum v. New York Life Insurance Co., 228 U. S. 364, we must reverse the judgment below, but the District Court is directed on a new trial to enter judgment in accordance with this opinion.

Judgment reversed.

190–191 In United States Circuit Court of Appeals

[Title omitted.]

Judgment

April 14, 1924

Error to the District Court of the United States for the Southern District of New York.

This cause came on to be heard on the transcript of record from the District Court of the United States, for the Southern District of New York, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is reversed.

It is further ordered that a mandate issue to the said District Court in accordance with this decree.

H. W. R.

M. T. M.

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192 In United States Circuit Court of Appeals

Clerk's certificate

I, William Parkin, clerk of the United States Circuit Court of Appeals for the Second Circuit, do hereby certify that the foregoing pages, numbered from 1 to 191, inclusive, contain a true and complete transcript of the record and proceedings had in said court, in the case of Archibald Douglas, et al., as executors, etc., plaintiffs in error, against William H. Edwards, as collector, etc., defendant in error, as the same remain of record and on file in my office.

In testimony whereof, I have caused the seal of the said court to be hereunto affixed, at the city of New York, in the Southern District of New York, in the Second Circuit, this 27th day of June, in the year of our Lord one thousand nine hundred and twenty-four and of the independence of the said United States the one hundred and forty-eighth.

[SEAL.] WM. PARKIN, *Clerk.*

193 In Supreme Court of the United States

Order granting petition for certiorari

Filed Oct. 20, 1924

On petition for writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit.

On consideration of the petition for a writ of certiorari herein to the United States Circuit Court of Appeals for the Second Circuit, and of the argument of counsel thereupon had, it is now here ordered by this court that the said petition be, and the same is hereby, granted, the record already on file as an exhibit to the petition to stand as a return to the writ.

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In the Supreme Court of the United States

OCTOBER TERM, 1924

WILLIAM H. EDWARDS, COLLECTOR OF Internal Revenue, Petitioner
v.
ARCHIBALD DOUGLAS, GEORGE NOTMAN, and Edmund Coffin, as Executors of the Estate of James Douglas, deceased, Respondents } No. —

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

The Solicitor General on behalf of William H. Edwards, Collector of United States Internal Revenue for the Second District of the State of New York, prays that a writ of certiorari may issue to review the judgment of the United States Circuit Court of Appeals for the Second Circuit reversing a judgment heretofore rendered by the United States District Court for the Southern District of New York in favor of the petitioner and against the respondents.

STATEMENT OF THE CASE

This action was brought by respondents to recover the sum of $173,579.72, the amount of an additional

tax assessed on the income of their testator for the year 1917, and paid by them under protest to petitioner. The additional tax was assessed in respect to two distributions aggregating $328,400, made to Dr. Douglas in the year 1917 by Phelps Dodge Corporation, a mining corporation, in which he was a stockholder. It was stated in the resolutions declaring these distributions that the same were to be paid from the depletion reserve set up on the books of the corporation to make good the exhaustion of its mines caused by the extraction of the ores. It was claimed by Dr. Douglas in his income-tax return, and by respondents in their complaint, that for this reason these distributions were returns of capital and could not be taxed as income under the Sixteenth Amendment. The Commissioner of Internal Revenue rejected this claim because at the time of making these distributions Phelps Dodge Corporation had on hand a surplus greatly in excess of the amount of such distributions. He therefore treated them as income to the taxpayer, and since the corporation had for the year 1917 earnings sufficient to cover these, and all other, distributions made in that year, assessed a tax thereon at the rates prescribed by law for the year 1917.

Upon the trial of this action in the District Court respondents, while insisting that the aforesaid distributions were returns of capital and not income, made the further claim that if the same should be held to be income and taxable under the Revenue Act of 1917, by the provisions of Section 31 (b) of

that Act they are not taxable at 1917 rates. The District Court held that these distributions were income to Dr. Douglas and taxable at 1917 rates and dismissed the complaint upon the merits. Respondents sued out a writ of error and the Circuit Court of Appeals for the Second Circuit reversed the judgment, holding that the distributions were not returns of capital but were income and taxable as such, but that under Section 31 (b) of the Revenue Act of 1917 they were deemed to be paid from the surplus accumulated in the year 1916, and should be taxed at the much lower rates prescribed for that year. The basis of the decision is that "the most recently accumulated undivided profits or surplus," from which by the provisions of that section all distributions in the year 1917 are deemed to be made, does not include the current earnings for that year, but refers only to the surplus or undivided profits account of the corporation at the close of the last fiscal period.

THE QUESTION PRESENTED

Under section 31 (b) of the revenue act of 1917 are distributions made by a corporation to its shareholders in the year 1917 taxable to the shareholders at the rates prescribed by law for the year 1917, if the corporation has earnings for that year sufficient to pay them, or must they be allocated to the surplus accumulated in prior years and bear the lower rates of taxation prescribed for prior years?

REASONS FOR THE ISSUANCE OF THE WRIT

1. The question presented is of vital importance to the Government and to the public, not only because

of the large amount involved in this suit, and in other suits by stockholders of the same corporations involving the same distributions, but because of the large amounts of refunds that must be made to taxpayers generally if the decision of the Circuit Court of Appeals is to be accepted as final. The decision does not turn on any point peculiar to this case, but is of general application to all distributions made by a corporation to its stockholders in the year 1917. The Bureau of Internal Revenue has consistently ruled that all distributions made in 1917 are taxable at 1917 rates to the extent that the earnings of the corporation for that year are sufficient to cover the same. In the year 1917 vast distributions were made by many corporations to their stockholders from profits made from war activities. If all distributions in 1917 which have been taxed at 1917 rates are to be taxed at the much lower rates prescribed for the year 1916 or previous years, or are not to be taxed at all, the amount to be refunded, even allowing for the running of the five-year period of limitations on 1917 claims for refund, will be enormous and may seriously affect the fiscal policy of the Government.

2. A very large number of cases involving the question presented in this case are now pending in District Courts throughout the country and before the Treasury Department. Many such cases are being held dormant pending the final decision of this case. Decision by this court is necessary to

prescribe a uniform rule by which all such cases can be disposed of. It is of the utmost public importance that the business of the courts and of the Treasury Department should not be impeded by cases which can be settled by a final determination of this question in this case. By such a determination useless litigation at great expense to the taxpayer and the Government will be avoided.

3. The Circuit Court of Appeals has erroneously construed Section 31 (b) of the Revenue Act of 1917. As shown in the brief submitted herewith, the construction placed upon this section by the Circuit Court of Appeals is contrary to the plain intention of Congress, distorts the literal and commonly accepted meaning of the words used, leads to unjust and absurd results, and disregards the contemporaneous and long-continued construction of this section by the Treasury Department in which the taxpayer and the corporation here involved acquiesced.

Wherefore, it is respectfully asked that a writ of certiorari may issue to review the judgment of the United States Circuit Court of Appeals for the Second Circuit.

JAMES W. BECK,
Solicitor General.

BRIEF IN SUPPORT OF PETITION

Section of the statute involved

Section 31 (b) of the Revenue Act of 1916, added by Section 1211 of the Revenue Act of 1917 (Act of October 3, 1917, 40 Stat. 300), provides in part as follows:

> Any distribution made to the shareholders * * * of a corporation * * * in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation * * *, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed * * *, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen.

ARGUMENT

The Circuit Court of Appeals has held that "the most recently accumulated undivided profits or surplus" from which distributions by a corporation in 1917 are deemed to have been made is limited to such undivided profits and surplus as have been definitely ascertained by a closing of the books and does not include current earnings on hand at the time of the distribution.

The meaning of this section is made clear by a consideration of the circumstances attending its enactment. This section became law as part of the Revenue Act of 1917, the first revenue statute enacted by Congress after the entry of the United States into the World War. By this statute the rates of income tax were greatly increased over the rates prescribed by the Revenue Act of 1916, a heavy excess-profits tax was enacted, and many new and increased taxes were imposed. The purpose of this increased taxation was to enable the Government to defray the heavy expenses incident to the war. At the same time business was disturbed. New war industries sprang into being, and established concerns, the products of which were not essential to the prosecution of the war, were unable to operate at a profit, and were forced to draw upon the surplus accumulated in prior years in order to pay dividends.

In the income tax acts passed prior to the Revenue Act of 1917 dividends were subject to taxation at the rates prescribed for the year in which they were paid, the only exception being that under the Reve-

nue Act of 1916 dividends declared by a corporation out of its surplus accumulated prior to March 1, 1913, were held to be exempt from tax. The bill as it passed the House of Representatives taxed all dividends at 1917 rates, except dividends declared from March 1, 1913, surplus. In the Senate, however, the case of a stockholder receiving dividends from a corporation, which, owing to war conditions, was not operating at a profit, but was drawing upon its surplus accumulated in prior years, was considered, and it was deemed inequitable to tax him at the high 1917 rates on dividends paid from surplus accumulated when the tax rate was low. The result was the rules of allocation contained in Section 31 (b).

The plain meaning of this section is that distributions to stockholders are to be regarded as having been made from the most recent earnings of the corporation and are to bear the tax rate prescribed for the year in which such earnings accrued. The Circuit Court of Appeals correctly holds that the word "deemed" creates a conclusive presumption which can not be set aside by any declaration of the corporation that the distribution is made from some other fund. So construed this section lays down a rule of taxation which has regard both to the necessities of the Government and the equities of the taxpayer, namely, that distributions made in 1917 shall first be applied to 1917 earnings and taxed at 1917 rates, so far as such earnings are sufficient to cover the same, and any excess of distributions over earn-

ings shall be applied to any undistributed earnings of 1916, and taxed at 1916 rates, and so on, until all earnings accumulated since March 1, 1913, have been distributed, when tax-free distributions of earnings accumulated prior to that date may be made.

This construction is in accordance with the literal and commonly accepted meaning of the words "surplus" and "undivided profits".

Surplus is commonly used to denote excess of assets over and above liabilities and capital. This definition may be found in dictionaries, works on accounting, and court decisions. It is even adopted by the Circuit Court of Appeals in its decision. If this definition is correct the surplus at any given time is the excess of assets over liabilities and capital as it exists at that time, and the most recently accumulated surplus is the excess most recently acquired, namely, the most recent current earnings, whether or not there has been a balancing of the books and a closing into a surplus account. Clearer still is the term "undivided profits." The Circuit Court of Appeals in its opinion thus defines "undivided profits":

> It means such profits as exist and have or have not been ascertained, but, in any event, have not been distributed or otherwise used * * *.

Such profits as exist and have or have not been ascertained and have not been distributed is the exact description of current earnings to which it is petitioner's contention that all distributions in 1917 must first be allocated. The term "undivided

profits" is used in Section 207 of the same Act to mean current profits, which are excluded from invested capital under the phrase "undivided profits earned during the taxable year."

To construe "the most recently accumulated undivided profits and surplus" as "the most recently accumulated undivided profits and surplus *account*" of the corporation is to extend the liberal meaning of the words, and it has been recently said by this court:

> But in statutes levying taxes the literal meaning of the words employed is most important, for such statutes are not to be extended by implication beyond the clear import of the language used. *United States* v. *Merriam*, 263 U. S. 179.

Literally, therefore, "the most recently accumulated undivided profits or surplus" are the most recent current earnings, and unless this construction is adopted all of the provisions of this section cannot be construed consistently with each other. In the last clause of this section it is provided that earnings and profits accrued prior to March 1, 1913, may be distributed exempt from the tax only after distribution of all earnings and profits accrued since that date has been made. This is an absolute rule of law prohibiting a tax free distribution of earnings accrued prior to March 1, 1913, until all subsequent earnings and profits, including current earnings and profits, have been distributed. If a corporation in 1917 has on hand a surplus accumulated prior to March 1,

1913, and a large amount of current earnings, which it distributes to its stockholders, every distribution which it makes is conclusively presumed to have been made from the most recently accumulated surplus, which by hypothesis under the construction of the Circuit Court of Appeals is the March 1, 1913, surplus. Since there was no tax in force at that time by the first clause of Section 31 (b) such a distribution would be tax free. By the last clause, however, no tax free distribution can be made of March 1, 1913, surplus until all current earnings have been distributed. At what rate then shall such a distribution be taxed? This question cannot be answered under the construction adopted by the Circuit Court of Appeals.

Furthermore, if a corporation had a deficit at the beginning of 1917 or if it was not organized until that year, and made large profits which it distributed to its stockholders, are these distributions tax free or are they taxable at 1917 rates? This was a very common case and could not have been overlooked by Congress. If the answer is that such distributions are taxable at 1917 rates, then "the most recently accumulated undivided profits or surplus" does include current earnings, as petitioner contends, and the construction of the Circuit Court of Appeals is erroneous. If the answer is that they are tax free, because there is no undivided profits or surplus account to which they can be allocated, the conclusion is absurd, since Congress can not have intended to exempt an individual from taxation on distributions

received in 1917 because of the previous financial condition of the corporation making the same.

It is also apparent that under this construction the tax rate of individuals depends upon when and how often the corporation closes its books. One who is so unfortunate as to be a stockholder in a corporation which has a fiscal year ending in the middle of the year and pays its dividends in the latter part of the year may find the greater part of his distributions taxed at 1917 rates, whereas another who is a stockholder in a corporation on a calendar year basis would pay a tax at the much lower 1916 rates. Stockholders in corporations closing their books monthly, quarterly, or semiannually would pay taxes at 1917 rates on a large part of their distributions, whereas stockholders in corporations closing their books annually on a calendar year basis, but making the same earnings, would pay at most only the 1916 rates. The rate of taxation of individuals is made to depend upon the bookkeeping methods of corporations in which they are stockholders instead of upon the facts, which is unequal and unjust.

This construction also leads necessarily to the conclusion that Congress intended to discriminate in favor of income derived from dividends and against income derived from interest, rent, and personal efforts. No reason has ever been advanced for such a discrimination. With the exigencies of the war requiring the tapping of every available source of revenue, and with the abnormal war profits coming to individuals largely through dividends from cor-

porations making such profits, it is unreasonable to suppose that Congress would have provided that dividends should in most cases be taxed at a much lower rate. Certainly a discrimination so unjust and so baseless should not be imputed to Congress if a more reasonable interpretation of the statute is possible.

> We are therefore bound to give heed to the rule, that where a particular construction of a statute will occasion great inconvenience or produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute. *Knowlton* v. *Moore*, 178 U. S. 41, at page 77.

The Circuit Court of Appeals relies strongly upon the fact that corporations which must take extensive inventories and close their books annually can not know at any intermediate time what, if any, profits have been made. It is not perceived how this has any bearing on the construction of Section 31 (b). By trial balance or otherwise directors can ascertain with reasonable certainty at any time what profits have been made, and ultimately the time will come when the profits will be exactly determined and it can be known with certainty whether they are sufficient to cover the distributions for the year. Dividends are commonly gauged by, and paid out of, current earnings even by corporations of this nature. Furthermore, this section is of general application, and most corporations are able to tell exactly what are their earnings and profits for the year at any time. It is generalizing the particular to make the

accounting methods of a few of the larger and wealthier corporations determine the construction of this section.

Lastly, it may be pointed out that the construction of this section by the Treasury Department was adopted by the very corporation and taxpayer involved in this case. Phelps Dodge Corporation in its annual statement to stockholders stated that all of its dividends, except one in March, which was said to be from 1916 earnings, and the so-called depletion distributions were paid from 1917 earnings, and Dr. Douglas so reported them in his income tax return for that year. This construction was first promulgated by the Treasury Department in Article 107 of Regulations 33 Revised, issued in January, 1918, and there has never been any ruling or practice inconsistent therewith. It was approved simultaneously, but independently, by the District Court in the case at bar and by the United States District Court for the Northern District of New York in the case of *Harder* v. *Irwin*, 285 Fed. 402. It is the only construction which is consistent with the words used and the plain intention of Congress, and the only one under which inconsistent, unjust, and absurd results can be avoided.

Wherefore, it is respectfully submitted that a writ of certiorari should issue to review the judgment of the Circuit Court of Appeals for the Second Circuit to the end that said judgment may be reversed and the judgment of the District Court be reinstated.

JAMES M. BECK,
Solicitor General.

JULY, 1924.

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In the Supreme Court of the United States

OCTOBER TERM, 1924

WILLIAM H. EDWARDS, COLLECTOR OF INTERNAL REVENUE, petitioner
v.
ARCHIBALD DOUGLAS, GEORGE NOTMAN, AND Edmund Coffin, as Executors of the Estate of James Douglas, Deceased

No. 524

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER

STATEMENT OF THE CASE

This cause is before this court on a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit to review a judgment reversing a judgment of the United States District Court for the Southern District of New York, dismissing the complaint upon the merits.

The action was brought to recover the sum of $173,579.72, additional income tax assessed against respondents upon the income of their testator, Dr. James Douglas, for the year 1917, and paid by them under protest. The additional tax sought to be

recovered was levied upon two cash distributions received by Dr. Douglas from Phelps Dodge Corporation, in September and December, 1917.

The case was tried in the District Court before Honorable Julian W. Mack, Circuit Judge, and a jury of one, upon an agreed statement of facts and documentary evidence introduced by both parties. Upon the trial respondents, while claiming that the distributions in question were returns of capital to their testator and not income, asserted the further claim that even if such distributions should be held to be income, they were not taxable at the rates prescribed for the year 1917. At the close of the testimony each side moved for the direction of a verdict, upon which motions decision was reserved. Thereafter the learned District Court directed a verdict for the petitioner, and upon this verdict a judgment dismissing the complaint upon the merits was entered. *Douglas* v. *Edwards*, 287 Fed. 919.

Respondents then sued out a writ of error to the United States Circuit Court of Appeals for the Second Circuit. Upon the argument in that Court respondents again urged that the distributions in question were returns of capital to the taxpayer, and not income, and that even if held to be income were not taxable at 1917 rates. The Circuit Court of Appeals held that the distributions were not returns of capital, but were income and taxable as such under the Revenue Act of 1917 (Act of October 3, 1917, c. 63, 40 Stat. 300), but that under

Section 31 (b) (*Id.* 338), of that Act the same were taxable at 1916 and not at 1917 rates. The judgment of the District Court was therefore reversed, and it is to review this judgment of reversal that the present writ has issued. *Douglas* v. *Edwards*, 298 Fed. 229.

THE FACTS

The facts disclosed by the record material to the issues here involved are as follows:

For many years prior to April 1, 1917, respondents' testator, Dr. James Douglas, had been a stockholder (p. 27) in Phelps Dodge & Company, Inc., a New York Corporation, engaged in the business of mining copper and coal through various subsidiaries (p. 29). On April 1, 1917, an internal reorganization of the business took place (pp. 27–29), and in this reorganization the parent company, Phelps Dodge & Company, Inc., was dissolved, and one of the subsidiaries changed its name to Phelps Dodge Corporation and itself became the parent company. The stockholders, including Dr. Douglas, exchanged their stock in the old company for stock in the new, share for share, and the business was continued as formerly. It is agreed by both sides that this reorganization was a mere change of form and that for the purposes of this case the parent company and its subsidiaries may be treated as one enterprise, and the new parent company as a continuation of the old. For clearness therefore the company will hereafter be referred to as Phelps Dodge Corporation, it being

understood that under this name will be included the various subsidiaries and the old company.

On March 1, 1913, Phelps Dodge Corporation, according to a provisional valuation made by the Bureau of Internal Revenue in 1920, and as found by the District Court, had total assets of $153,275,606.69 (p. 24), of which $45,000,000 represented capital stock, $45,000,000 (p. 35), paid in surplus, and the balance, namely, $63,275,606.69, appreciated and earned surplus, made up of appreciation in the value of the mines and of actual earnings. After March 1, 1913, the company continued to operate and each year in computing its net income for income tax purposes, deducted from its gross income and credited on its books to a depletion reserve, an amount necessary to make good the wasting of the value of the mines due to the extraction of the ores. When the provisional valuation was made by the Bureau of Internal Revenue in 1920 this depletion reserve was revised and increased from $14,416,783.88 at the end of 1917 to $25,837,427.91 (p. 32), and the company's income and excess profits taxes were adjusted accordingly. During the years 1913, 1914, and 1915 the company's earnings over and above its deduction for depletion were $6,373,116.86, $3,643,458.10, and $5,623,523.89, respectively, and its distributions to stockholders $7,425,000, $6,300,000, and $9,000,000, respectively (p. 24), so that the distributions in those years exceeded the earnings by $7,084,901.15, which was paid out of the surplus accumulated

prior to March 1, 1913, as the only fund available for such payment.

In 1916 the company's earnings over and above the depletion deductions fixed by the Bureau aggregated $17,750,621.67 and its distributions amounted only to $14,625,000 (p. 24). There was therefore an excess of earnings over distributions of $3,125,621.67. At the close of 1916 the company had a surplus of $104,316,327.21, composed, as stated above, of a paid-in surplus of $45,000,000 and the balance of earned and appreciated surplus. In 1917 the earnings of the company, after deducting the allowed depletion, amounted to $16,742,487.06 and its regular distributions to $10,800,000 (p. 24). In September, 1917, the Board of Directors attempted to declare what it was pleased to call a "depletion dividend" of $3.00 a share (p. 32). By a resolution adopted at a meeting of the Board on September 13, 1917, a dividend of this amount was declared out of the "depletion account" of the company. The preamble to the resolution declaring this dividend recited that the company yearly in computing its income had deducted therefrom a reasonable allowance for depletion of its mines based upon the value thereof as of March 1, 1913, and that the Income Tax Law and the rulings of the Bureau of Internal Revenue provide for a separation of this deduction from income and that payments therefrom to stockholders should be a return of capital and not subject to income tax in their hands. The purpose of the resolution was clearly

to make a capital distribution and to relieve the stockholders from income-tax liability thereon.

The distributions directed by this resolution were accordingly made and Dr. Douglas received the sum of $123,150 as his proportionate part thereof (p. 32). On December 13, 1917, by a similar resolution another " depletion dividend " of $5.00 a share was declared and upon this distribution Dr. Douglas received the sum of $205,250 as his proportionate share thereof (p. 33). These distributions were not treated upon the books of the company like ordinary dividends, but were carried through a series of special accounts fully set forth in the record but not material to the questions here presented (p. 35).

The result was that the company with net earnings for the year of $16,742,487.06 distributed to its stockholders either by dividends declared by resolutions in the usual form or by the so-called " depletion dividends " $14,400,000. At the close of the year 1917 the company had a surplus of $106,658,814.27 (p. 24). Furthermore as found by the District Court (p. 23) the earnings of the company for the year 1917 over and above all previous distributions were sufficient at the time of the declaration and payment of these " depletion dividends " to pay the same. This finding is apparently not disputed by respondents.

In filing his income tax return for the year 1917, Dr. Douglas did not include as part of his income subject to tax the amount of the so-called "deple-

tion dividends" received by him. He did, however, annex a statement to his return showing that he had received $328,400 as his proportionate share of these distributions (p. 77). Upon audit of his return the Commissioner of Internal Revenue included this sum in his income and assessed an additional tax thereon at the rates prescribed by law for the year 1917 (p. 36). Dr. Douglas having died, this additional tax was paid by respondents, his executors, to petitioner under protest, a claim for refund of the same was duly filed and rejected, and subsequently this action was brought to recover the same.

A consideration of the record discloses certain other facts which have a bearing upon the issues here presented. In the first place Dr. Douglas returned all the dividends received by him from Phelps Dodge Corporation, except the so-called "depletion dividends" and the one declared and paid by the company in March, 1917, as taxable at 1917 rates (p. 75). The company treated all dividends, except the March dividend and the so-called depletion dividends, as having been paid from 1917 earnings, and did not reduce its invested capital for excess profits tax purposes by the amount of any such dividends. In the annual report by Phelps Dodge Corporation to its stockholders, dated February 28, 1918, it is said (p. 55):

> Of these dividends, as pointed out in a statement to stockholders under date of January 29, 1918, the dividend paid in March,

> 1917, was paid by Phelps Dodge & Company and was declared and paid entirely out of the profits accrued during the year 1916. The other three regular dividends and extras were paid by Phelps Dodge Corporation out of earnings for the year 1917, and the special dividends of September and December were a "distribution from the reserve for depletion."

In failing to include the amount of these depletion dividends in his income for the year 1917 Dr. Douglas took the ground that the same had been declared and paid from the depletion reserve of the company and were therefore returns of capital to him. In the protest filed by respondents the same ground is elaborately set forth (pp. 10–12) and the claim is specifically made that the tax on these depletion dividends is illegal and void since the same were not distributions from the surplus and undivided profits of the company, but were distributions of capital, and therefore not subject to tax as income under the Sixteenth Amendment. In the claim for refund the language of the protest is repeated (pp. 79–82), and the claim is based upon the ground that a tax upon these distributions is a tax upon capital. The complaint is framed upon the same theory. Paragraphs "Twenty-third" to "Twenty-seventh" inclusive (p. 7), base the alleged illegality of the tax upon the claim that the tax is levied in respect to a capital distribution and that the provisions of the Revenue Act of 1917 in so far as they purport to impose a tax thereon are

unconstitutional and void. Nowhere in the record of this case prior to the trial is any claim made that the rate of taxation upon these distributions was erroneous, or that the same if taxable at all should be taxed at any rate other than that prescribed for the year 1917.

At the trial of this case in the District Court the claim was made for the first time that even if these distributions should be held to be income, under Section 31 (*b*) of the Revenue Act of 1917 they could not be taxed at the rates prescribed for the year 1917. The learned District Court held that these distributions were not distributions of capital but were distributions of income and as such were taxable under the Revenue Act of 1917, since a corporation having a surplus and making no reduction in its capital stock can not make a distribution of capital. It likewise held that since the corporation had on hand at the time of the distributions earnings for the year 1917 more than sufficient to cover the same, they were taxable to the stockholder at the rates prescribed by law for that year.

On writ of error sued out by respondents the Circuit Court of Appeals for the Second Circuit sustained the District Court in holding that the distributions in question were income and not capital, but held further that under Section 31 (*b*) of the Revenue Act of 1917, they must be deemed to have been paid out of the surplus which the company had on hand at the beginning of the year, and were

therefore taxable only at the rates prescribed for the year 1916 and not at the rates prescribed for the year 1917. No review of the decision of the Circuit Court of Appeals holding that the distributions were income, and not capital, has been sought by respondents and this point must therefore be taken as settled. The writ of certiorari in the case at bar was applied for in order that the correctness of the construction of Section 31 (*b*) by the Circuit Court of Appeals might be passed upon by this Court.

THE QUESTION PRESENTED

Under Section 31 (*b*) of the Revenue Act of 1917 (40 Stat. 338) are distributions made by a corporation to its shareholders in the year 1917, taxable to the shareholders at the rates prescribed by law for the year 1917, if the corporation has earnings for that year sufficient to pay them, or must they be allocated to the surplus accumulated in prior years and bear the lower rates of taxation prescribed for those years?

SECTION OF THE STATUTE INVOLVED

Section 31 of the Revenue Act of 1916, added by Section 1211 of the Revenue Act of 1917 (Act of October 3, 1917, ch. 63, 40 Stat. 300, 337–338), provides:

> Sec. 31 (*a*). That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, associa-

tion, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income to the amount of the earnings or profits so distributed.

(*b*) Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior

to March first, nineteen hundred and thirteen.

ARGUMENT

INTRODUCTION

It is the contention of the Government that under Section 31 (*b*) of the Revenue Act of 1917 distributions by a corporation to its shareholders in the year 1917 must be allocated to the earnings of the corporation for that year, and, if such earnings are sufficient to cover the same, must be taxed to the shareholder at the rates prescribed for that year. It is the contention of respondents, and the holding of the Circuit Court of Appeals, that such dividends must be allocated to the undivided profits or surplus account of the corporation as the same appeared on its books at the close of the last fiscal period and must be taxed to the stockholder at the lower rates prescribed for the year or period in which such surplus was accumulated.

The question of the construction of Section 31 (*b*) of the Revenue Act of 1917 is one of general application and does not in any way depend upon the peculiar facts of this case. The distributions here involved having been held by the Court below to be distributions of surplus, and therefore income, the only question now presented is, at what rate shall they be taxed? The answer to this question depends entirely upon whether by the phrase "most recently accumulated undivided profits or surplus" in Section 31 (*b*), to which all

distributions made by a corporation to its shareholders in the year 1917 must be allocated, Congress intended to include current earnings of the year in which the distribution was made, or whether, as held by the Circuit Court of Appeals, it intended to exclude such current earnings and referred only to the undivided profits or surplus account of the corporation as shown by the books at the close of the last fiscal period.

Much will of necessity be said concerning the accounting methods of corporations and of the practice of directors in declaring and paying dividends. In all this discussion it should be borne in mind that the tax involved is in no sense a tax on Phelps Dodge Corporation. It is a tax on the income of Dr. Douglas, and the accounting practices and bookkeeping methods of the corporation will be considered only because the claim is made that by reason of such methods and practices Dr. Douglas is entitled to be taxed at a lesser rate on certain distributions than is prescribed by law for income from other sources.

The principle underlying all income taxation is that the common burden shall be distributed among taxpayers according to their ability as reflected by their net income to bear it. The receipt of a given income calls for the payment of a certain tax. If a taxpayer receives income but claims that by the terms of the statute it is taxable at a lower rate than that prescribed for other income it is his duty to

point to some provision of the statute which clearly and unmistakably grants him such preferential treatment. In the argument which follows, this aspect of the case should not be forgotten. Section 31 (*b*) of the Revenue Act of 1917 does not deal with taxes imposed on corporations, nor does it lay down a rule of law about the declaration of dividends. It simply prescribes the rates at which a certain kind of income shall be taxed.

CONTENTIONS OF THE UNITED STATES

What then is the meaning of Section 31 (*b*)? It is the contention of the Government that—

(1) Well-settled principles of statutory construction require that the language of this section should not be extended by implication to grant this taxpayer a lower rate of tax.

(2) The circumstances attending the enactment of Section 31 (*b*) show clearly that it was the intention of Congress that distributions made by a corporation to its shareholders in the year 1917 should first be allocated to the earnings for that year and be taxed at 1917 rates and that only the excess of distributions over earnings should be allocated to the earnings of previous years and bear the lower rates of taxation.

(3) The literal construction of this section requires that dividends paid in 1917 should first be allocated to the earnings of the corporation for that year and be taxed at 1917 rates.

(4) The construction adopted by the Circuit Court of Appeals leads to such unjust and absurd results and produces such inequalities in taxation among individuals that it should not be upheld, since a more reasonable interpretation is present in the statute.

(5) The construction adopted by the Circuit Court of Appeals disregards the long-continued and practical construction of this section by Treasury officials, taxpayers, and corporations, including the taxpayer and corporation here involved.

Point I

Well-settled principles of statutory construction require that the language of Section 31 (b) should not be extended by implication to grant this taxpayer a lower rate of tax

Much was said by respondents in the Courts below about the principle of statutory construction that in case of doubt a taxing statute is to be construed most strongly against the Government and several decisions of this Court were cited in support thereof. It may be well at the outset of the argument to consider this contention in some detail in order to determine just what the so-called principle of strict construction means. It certainly does not mean that a taxing statute must always be construed so as to produce a smaller tax in a particular case. It is now well known that the construction of a taxing statute cuts both ways, and that a construction which results in a smaller tax

from one taxpayer will result in a larger tax from another. A construction which seems to one taxpayer to be strict against the Government will seem to another to be strict against him. It is a question of whose ox is gored.

Take for instance the effect of the very section now under consideration on the excess profits tax provisions of the Revenue Act of 1917. If as held by the Circuit Court of Appeals the phrase " most recently accumlated undivided profits or surplus " does not embrace current earnings for the year, but refers only to the undivided profits or surplus account, as it appeared on the books at the close of the preceding fiscal year, and if dividends paid in 1917 must be deemed to have been paid from such account, it is obvious that the invested capital of many corporations for 1917 would of necessity be reduced by the total amount of dividends paid during the year. Since, by the excess-profits tax provisions, the smaller the invested capital the higher the tax, a reduction in invested capital would be a very serious matter to a large number of corporations, and would result in their paying large additional excess-profits taxes. A construction which might seem strict against the Government to a taxpayer seeking to have the taxes on his distributions reduced would seem most strict against the taxpayer to such a corporation when the additional assesment comes through. No progress can therefore be made by appealing to this alleged rule in determining the effect to be given to Section

31 (*b*). The rule of construction, is not that in case of doubt a taxing statute should be construed in favor of a reduction on the tax to a particular taxpayer, but that the words of a taxing statute must not be extended to include any person or matter not strictly within the meaning of the words used, and if there is any doubt it will be resolved against any such extension. The principle has been stated by this Court in the case of *United States* v. *Merriam*, 263 U. S. 179, at pages 187–188, as follows:

> On behalf of the Government it is urged that taxation is a practical matter and concerns itself with the substance of the thing upon which the tax is imposed rather than with legal forms or expressions. But in statutes levying taxes the literal meaning of the words employed is most important, for such statutes are not to be extended by implication beyond the clear import of the language used. If the words are doubtful, the doubt must be resolved against the Government and in favor of the taxpayer. *Gould* v. *Gould*, 245 U. S. 151, 153 (38 Sup. Ct. 53, 62 L. Ed. 211). The rule is stated by Lord Cairns in *Partington* v. *Attorney General*, L. R. 4 H. L. 100, 122:
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> " I am not at all sure that in a case of this kind—a fiscal case—form is not amply sufficient; because, as I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law he must be taxed, however great the hardship may appear to the judi-

> cial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."

It will be shown below that the construction here contended for is the literal construction of the language used in Section 31 (*b*).

There is, however, another aspect of the case which requires careful consideration. In the cases in which the so-called rule of strict construction against the Government of a taxing statute is laid down the Government was attempting to subject to the tax matters not clearly embraced within its terms. This is not the situation in the case at bar. Here the distributions have been held to be income and to come within the general provisions of the Revenue Act imposing a tax on incomes. Section I of the Revenue Act of 1916 imposes normal and additional taxes at specified rates upon the "net income received in the preceding calendar year from all sources by every individual, etc." Section 1 of the Revenue Act of 1917 (40 Stat. 300) imposes further normal taxes upon the net income of every individual, and Section 2 of that Act (40

Stat. 301) further additional or surtaxes. Section 2 (*a*) of the Revenue Act of 1916 (39 Stat. 756, 757), as amended by Section 1200 of the Revenue Act of 1917 (40 Stat. 329), defines net income as follows:

> (*a*) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trades, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

Had Section 31 (*b*) not been enacted these distributions would unquestionably be taxable at the rates prescribed by Section 1 of the Revenue Act of 1916 and Sections 1 and 2 of the Revenue Act of 1917. If now a claim is made that by reason of Section 31 (*b*) they are taxable at different and lower rates, it is clear that a case is not presented in which the Government is trying to subject to the tax something which otherwise would be exempt, but the case is one in which the taxpayer is asserting that income otherwise subject to certain rates of

tax is by that section to be taxed at lower rates. In other words, the instant case does not involve the imposition of the tax upon a given subject or the question of a statutory exception to the taxable class. It involves rather the *exemption* of matters otherwise subject to the tax at certain rates from such rates, and in such case the rule of law is not that the provisions of the statute under which such exemption is claimed must be construed strictly against the Government but that in case of doubt such provisions must be construed strictly against the taxpayer.

This distinction was pointed out by the Court in *Eidman* v. *Martinez*, 184 U. S. 578 at page 583, as follows:

> It is an old and familiar rule of the English Courts, applicable to all forms of taxation, and particularly special taxes, that the sovereign is bound to express its intention to tax in clear and unambiguous language, and that a liberal construction be given to words of *exception* confining the operation of duty (*Warrington* v. *Furbor*, 8 East, 242, 247; *Williams* v. *Sanger*, 10 East, 66, 69; *Denn ex dem. Manifold* v. *Diamond*, 4 Barn. & C. 243, 245; *Tomkins* v. *Ashby*, 6 Barn. & C. 541; *Doe ex dem. Scruton* v. *Smith*, 8 Bing. 146, 152; *Wroughton* v. *Turtle*, 11 Mees. & W. 561, 567; *Gurr* v. *Scudds*, 11 Exch. 190), though the rule regarding *exemptions* from general laws imposing taxes may be different. *Cooley, Taxn.* 146; *Re Enston*, 113

N. Y. 174, 177, *sub nom. People* v. *Sherwood*, 3 L. R. A. 464, 21 N. E. 87.

The case of exemptions claimed by a taxpayer has been specifically considered by this Court in other cases.

> Taxes being the sole means by which sovereignties can maintain their existence, any claim on the part of anyone to be exempt from the full payment of his share of taxes on any portion of his property must on that account be clearly defined and founded upon plain language. There must be no doubt or ambiguity in the language used upon which the claim to the exemption is founded. It has been said that a well-founded doubt is fatal to the claim; no implication will be indulged in for the purpose of construing the language used as giving the claim for exemption, where such claim is not founded upon the plain and clearly expressed intention of the taxing power.
>
> *Bank of Commerce* v. *Tennessee*, 161 U. S. 134, at page 146.
>
> But if there were a doubt as to the meaning of the statute that doubt should be resolved in favor of the government. Whoever claims a privilege from the Government should point to a statute which clearly indicates the purpose to grant the privilege.
>
> *Cornell* v. *Coyne*, 192 U. S. 418, at page 431.

From these authorities it is plain that in a case like the present the so-called rule of strict con-

struction of a taxing statute against the Government has no application. Section 31 (*b*) is to be construed like any other statute; its language is not to be extended in order to bring within the taxable class matters not clearly covered or in order to grant to this taxpayer exemption from taxes otherwise clearly imposed upon him; and if there is any doubt as to whether he is entitled to such exemption that doubt is to be resolved in favor of the Government and not in favor of the taxpayer.

Point II

The circumstances attending the enactment of Section 31 (b) of the Revenue Act of 1917 show clearly that it was the intention of Congress that distributions made by corporations to their shareholders in the year 1917 should first be allocated to the earnings of the corporation for that year and should be taxed at 1917 rates, and that only the excess of distributions over earnings should be allocated to earnings accumulated in prior years and bear lower rates of taxation

The Revenue Act of 1917 was passed almost six months after the United States had entered the World War, at a time when large profits were being made by a great many corporations and when additional revenue was urgently needed by the Government to defray the heavy expenditures incurred and to be incurred in the prosecution of the war. Congress in this Act imposed far higher taxes upon income than had been imposed by prior Revenue Acts and in addition levied heavy excess-profits taxes on individuals and corporations. These heavy taxes applied to all forms of income, earned

and unearned, and imposed burdens upon the citizen theretofore unheard of. Under the Income Tax Act passed on October 3, 1913, ch. 16, 38 Stat. 114, all dividends distributed after March 1, 1913, were taxable, whether the profits out of which such dividends were declared were accumulated before or after that date. *Lynch* v. *Hornby,* 247 U. S. 339; *Peabody* v. *Eisner,* 247 U. S. 347. The Revenue Act of September 8, 1916, ch. 463, 39 Stat. 756, permitted the declaration of dividends out of surplus accumulated prior to March 1, 1913, tax free, even though profits earned subsequent to March 1, 1913, remained undistributed. With this exception dividends under both Acts, although exempt from normal tax upon the theory that the normal tax had been paid by the corporation, bore the same rate of surtax as other income; and in the House bill the provisions of the Revenue Act of 1916 were left unchanged. When the bill reached the Senate, however, the question of dividends received further consideration.

A stockholder in a corporation having on hand a large amount of undistributed earnings of prior years, but which owing to the disturbed condition of business brought about by the war was unable to operate at a profit, presented a case of peculiar difficulty and hardship. In order to pay dividends in 1917 the corporation would be forced to draw upon its surplus of prior years, and it was clear that if such dividends were to be taxed at the high 1917 rates distributions would be greatly curtailed.

This would be a hardship on the stockholder and a loss to the Treasury; and even if such distributions could be compelled, it was not considered fair that they should be taxed at 1917 rates when it was clear that the only earnings which could be distributed were the earnings of prior years accumulated when the tax rate was low. At the same time, the necessities of the Treasury and the large earnings that were being made by corporations engaged in some form of war activity during 1917 rendered it imperative that corporations should not have the right to decide from what earnings their cash distributions were coming. The natural desire on the part of stockholders to escape the heavy tax rates for the year 1917 would have led directors to declare their distributions from surplus accumulated prior to March 1, 1913, or from surplus accumulated when the tax rate was low. The result was the rules of allocation laid down in Section 31 (*b*).

It is obvious that Section 31 (*b*) exempts from taxation only one form of income, namely, a distribution out of earnings and profits accrued prior to March 1, 1913, absolutely, if the distributions were made prior to August 6, 1917, and if made subsequent to that date, only if all earnings and profits accrued subsequent to March 1, 1913, have first been distributed.

It is also clear that by using the word "deemed," the statute laid down a rule of law as to the rate at which distributions should be taxed, which could

not be changed by a declaration of the Board of Directors as to the surplus from which the distribution was supposed to have been made. This was held by the court below and there can be no doubt of the correctness of this ruling.

The word " deemed " has been held to be synonymous with " adjudged," " considered," " regarded," and " determined " (*Cardinel* v. *Smith,* Fed. Cas. No. 2395; *Leonard* v. *Grant,* 5 Fed. 11, 16; *Harder* v. *Irwin,* 285 Fed. 402, 406), and if in Section 31 (*b*) any of these synonyms are substituted it becomes perfectly plain that what Congress intended by the language of that section is that any distribution made by a corporation to its stockholders in the year 1917 should be treated for the purpose of computing the tax thereon as if it had been declared by the directors from the most recently accumulated undivided profits or surplus, and nothing in the resolution declaring the dividend should in any way change the rate at which it should be taxed.

Bearing in mind the fact that this section lays down a rule of law as to the rates at which distributions made in 1917 should be taxed, the question arises, what did Congress mean by the phrase " the most recently accumulated undivided profits or surplus "? Did it intend that this phrase should include earnings for the year 1917 on hand at the time of the distribution, or did it intend that it should refer only to the undivided profits or surplus account of the corporation as it appeared on

the books at the close of the last fiscal period, and that notwithstanding large 1917 earnings, dividends should be allocated to such undivided profits or surplus account and bear the lower rates of taxation prescribed for some prior year?

The Court below, in holding that only the surplus or undivided-profits account of the corporation as it appeared on the books at the close of the last fiscal period was intended, relies most strongly on what it calls the legislative history of Section 31 (*b*). The bill as it originally passed the Senate contained the following provisions: (Cong. Rec., 65th Cong., 1st Sess., Vol. 55, Part 7, pp. 6869, 6870, 6877, 6886.)

> Provided, further, That any distribution made to the shareholders of a corporation, joint stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the net income of the years in which such distribution is made or, if such income is insufficient, from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the shareholder for the respective years in which earned by the corporation, joint stock company, or association, or insurance company, and shall be taxed to the shareholder at the rate prescribed by law for such year.

The bill went to conference and as reported by the Conference Committee contained Section 31 (*b*) in its present form. (Cong. Rec., 65th Cong.,

1st Sess., Vol. 55, Part 8, pp. 7613–7614.) The Court argues that the elimination of the provision allocating dividends to the net income of the corporation for the year in which earned and leaving the allocation only to the most recently accumulated undivided profits or surplus shows an intention on the part of the Conference Committee not to permit the allocation to current earnings but to confine it entirely to the undivided profits or surplus account of the corporation at the close of the last fiscal period.

This interpretation of this change is not sound. The utmost diligence on the part of counsel has failed to discover any statement in Congress which in any way explains this change or gives any reason therefor. This silence is in reality of more significance than the change itself. Under the Act of October 3, 1913, dividends were subject to taxation at the rates prescribed for the year in which they were paid. The same was true under the Revenue Act of 1916, the only exception being that dividends might be declared tax free from surplus existing on March 1, 1913. Under all subsequent revenue Acts dividends are taxed at the rates prescribed for the year in which paid.

The Revenue Act of 1917 in the form in which it passed the House provided for taxation of dividends at 1917 rates except dividends declared out of surplus accumulated prior to March 1, 1913, of which provision only a comparatively small number of corporations could take advantage. Yet the argu-

ment of the Court below is that a mere change in phraseology in a section of the bill is a sufficient basis for holding that Congress intended to introduce a far reaching change in income taxation; that with the exigencies of the War requiring the tapping of every available source of revenue Congress intended to forego taxes at 1917 rates on war profits coming to individuals in the form of dividends and seriously to reduce the amount of revenue to be derived from the bill below the estimates therefor, all without one word of explanation or comment. Surely, if it had been the purpose of this change in wording so to change the intention expressed in the Senate draft of the bill, some explanation of the reasons for the change would have been forthcoming. Some protest would certainly have been made against what must have seemed to many Members of Congress an unjust and unwarranted discrimination in favor of war profits and against income derived from permanent investments and personal efforts.

There is, however, a much more reasonable explanation of this change. It must be remembered that this is not a case of a change in a statutory provision which had been in force for a number of years and which had received both executive and judicial construction. In such a case the argument is undoubtedly sound that a change in the language indicates an intent to change the law. We are dealing here with an entirely new provision, which had not appeared in any prior Revenue Act,

and a change in the phraseology in the progress of the bill though Congress may mean no more than an improvement in draftsmanship, an expression of the same intention in more appropriate language.

An illustration of this may be found in the changes in the language of this very section in regard to taxing dividends from surplus accumulated in prior years at the rates prescribed by law for the years in which such surplus was accumulated. In the Senate bill this provision read:

> * * * shall constitute a part of the annual income of the shareholder for the respective years in which earned by the corporation * * * and shall be taxed to the shareholder at the rate prescribed by law for such year. (See page 26 this brief.)

In Section 31 (*b*) as finally enacted this provision reads:

> * * * shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation * * *.

In both cases the intention is the same, namely, that a stockholder receiving a distribution out of surplus accumulated when the tax rate was low should be taxed upon such distribution at the low rate. The language of Section 31 (*b*) used to express this intention is radically different from the

language used in the Senate draft of the bill, and the reason for this change is obvious. The Senate draft, if enacted into law, would have produced endless confusion in determining how income received in 1917 could possibly constitute a part of the income of the distributee for a prior year when he did not receive and had no right to receive the same. In the final form of the bill Congress, without in the least changing its intention, changed its language to express this intention more aptly.

In the same way Congress in eliminating the words " net income " did not change its intention of requiring dividends paid in any tax year to be allocated first to the current earnings of the year in which paid. It merely expressed that intention more appropriately. The phrase " net income " would not have brought about the result which both respondents and the learned Court below concede was intended by the Senate draft. Net income is not synonymous with current earnings. It is a purely statutory conception. Net income, under the statute, is to be determined by taking from gross income as defined certain specified deductions. The result is purely artificial and may or may not have any definite relation to actual income, earnings, or profits. Net income having been given this technical meaning in the act would have carried that meaning into Section 31 (*b*), and the use of this phrase might have excluded from the operation of the section large amounts of actual earnings and included therein legitimate expenses not allow-

able as deductions. It would also have given rise to most difficult questions in determining whether the "net income" was sufficient to cover the distributions made. For instance, would the "net income" to which dividends must be allocated be the total "net income" of the corporation, including the very substantial part which might be required to pay the excess-profits tax, or would it be only what was left after the excess-profits tax had been credited?

From the above it can readily be seen that if enacted in the form of the Senate bill the section would not have allocated dividends to current earnings but to an artificial "net income," entirely different from those earnings. The law in that form would certainly have been ambiguous and would have been a fruitful source of controversy and litigation. It doubtless would have been better if Congress in changing its language had used the phrase "most recently accumulated earnings and profits" which would have expressed its intention precisely. On the other hand, as will be shown below, the phrase "most recently accumulated undivided profits or surplus" literally construed does include current earnings and profits as well as surplus accumulated in the past and therefore aptly expresses the meaning attempted to be expressed by the Senate bill. Without doubt the changes made in the Conference Committee were designed not to change the meaning expressed in the Senate bill, but to

express that intention in clearer and more precise language.

Certainly there is nothing in any of the drafts of the bill in either the House or in the Senate which would lend color to the argument that Congress ever showed the slightest intention of exempting from taxation at 1917 rates dividends paid by a corporation which was making profits in that year sufficient to pay them. The bill as it passed the House made dividends paid in 1917 taxable at 1917 rates, unless specifically declared out of earnings or profits accrued prior to March 1, 1913. This made all dividends subject to the high surtax rates, except dividends received from the relatively few corporations which still had a surplus accumulated prior to March 1, 1913. The Senate went further and made a concession to the equity of stockholders in corporations, making no profits in the year 1917 on account of the general disturbance of business due to the war, which in paying dividends were obliged to draw upon their surplus of prior years.

But neither House nor Senate, nor any committee of either, ever exhibited the intention of allowing dividends paid in the year 1917 by corporations which had earnings for that year sufficient to pay them to be taxed at the lower rates prescribed for the year 1916 or former years. Surely if there had been an intention of changing the rule adopted in all other acts that dividends shall bear the tax rate of the year in which paid,

and of giving them favored treatment over income derived from interest, rents, profits on sales, and compensation for personal service, some explanation and justification of such an extraordinary change and discrimination would be found in the Congressional Record.

The Court below in support of its construction of Section 31 (*b*) goes into a very elaborate discussion of the dividend provisions of the Revenue Act of 1918 (Act of February 24, 1919, ch. 18, 40 Stat. 1057, 1059). It is a short and complete answer to the argument of the Court on this point to say that the Court entirely misconceived the nature of these provisions. The Revenue Act of 1918 taxed all cash dividends at the rates prescribed by law for the year in which paid irrespective of when the profits from which the same were paid had been accumulated. The only exception to this rule was that surplus accumulated prior to March 1, 1913, might be distributed free from tax after all earnings and profits accumulated since that date had been distributed. The rules of allocation of cash dividends laid down in Section 31 (*b*) of the Revenue Act of 1917 were therefore repealed by the provisions of the Revenue Act of 1918. By Section 201 (*d*) of that Act, 40 Stat. 1059, they were retained as a matter of equity in regard to stock dividends declared or paid between January 1 and November 1, 1918, before the Act was passed. This provision became unconstitutional by the decision of this Court in *Eisner* v. *Macomber,* 252 U. S. 189, and is of comparatively

slight importance. In particular, Section 201 (*e*) of the Revenue Act of 1918, and Section 201 (*f*) of the Revenue Act of 1921 (Act of November 23, 1921, ch. 136, 42 Stat. 227), providing that any distributions made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years, has been misunderstood by the Court. This is in no sense a provision in regard to the taxation of dividends.

Dividends paid in the first sixty days of any taxable year bear the rate of tax prescribed for that year. (*Adams* v. *United States,* decided by the Court of Claims Feb. 9, 1925; unreported to date.) This provision relates purely to the invested capital and excess profits tax of the corporation and provides that the invested capital of a corporation shall be reduced by the amount of distributions made during the first sixty days of any taxable year. In so far as this section has any relevancy to the case at bar it shows that notwithstanding the elaborate arguments of respondents and the Court below that dividends can not be declared out of current earnings, Congress in enacting the Revenue Acts of 1918 and 1921 recognized that they could be, and provided that such declarations should not reduce invested capital. It also shows that Congress used the word " accumulated " to designate earnings on hand and undistributed during the current year, a fact which the learned court apparently overlooks

in stressing so strongly the use of the word " accumulated " in the section under consideration.

Since, however, the Court below has relied so strongly on the provisions of the Revenue Act of 1918 (Act of February 24, 1919, ch. 18, 40 Stat. 1057), in order to discover the intention of Congress in enacting Section 31 (*b*) of the Revenue Act of 1917, it may not be amiss to consider a statement of the Committee on Ways and Means of the House of Representatives on September 3, 1918, reporting the bill which subsequently became the Revenue Act of 1918. It must be remembered that the Revenue Act of 1917 was passed at the first session of the Sixty-fifth Congress and the Revenue Act of 1918 at the second session of the same Congress. A report by the House Committee in charge of the new revenue bill made within a year of the passage of the former act, explaining such former act and the changes which it was desired to make in the new act, are certainly material to a consideration of the intention of Congress in the former act. The following statement in regard to the dividend provisions of the bill which subsequently became the Revenue Act of 1918 is to be found in the Congressional Record:

> The dividend provision makes any distribution made by a corporation out of its earnings or profits accrued since February 28, 1913, and payable to its shareholders or members, whether in cash or in other property or in stock of the corporation, subject to tax

in the hands of the shareholder, the same as under the present law. It also provides that any distribution made in 1918 or subsequent years shall be deemed to have been made from earnings or profits accrued since February 28, 1913. *The present law provides that dividends distributed to the stockholder shall be taxable to the individual at the income-tax rates in effect in the year in which the dividend is received, unless the corporation distributes more than its earnings for the taxable year, in which case the additional amounts so distributed are taxable in the hands of the individual at the rates in effect during the year in which the corporation earned the same.* Under the proposed bill all distribution of earnings accrued since February 28, 1913, will be taxable in the hands of the stockholder according to the rates in effect during the year in which the dividend is received. The proposed bill, like the present law, provides that earnings or profits accrued prior to March 1, 1913, may be distributed in stock dividends or otherwise exempt from tax after the earnings and profits accrued since February 28, 1913, have been distributed.

House Report No. 767, 65th Cong. 2d Session, dated Sept. 3, 1918, pp. 3–4. (Doc. Series 7308.) (Italics ours.)

Nothing could show more clearly the intention of the Committee of the same Congress which enacted the Revenue Act of 1917 as to the effect of Section 31 (*b*). In this statement the Committee

gives to this section the very construction for which the Government contends.

From the above it will be seen that the circumstances surrounding the enactment of this section show clearly that by the phrase "most recently accumulated undivided profits or surplus" to which all dividends are to be allocated Congress did not intend to exclude current earnings for the year but intended to include the same and to provide that all distributions made in the year 1917 should first be allocated to the earnings of that year, and that only when these were exhausted should resort be had to surplus accumulated in prior years.

Point III

The exact and literal meaning of the phrase "most recently accumulated undivided profits or surplus" embraces current earnings. To construe this phrase as excluding current earnings and referring only to the "undivided profits or surplus account" of the corporation as shown at the close of the last fiscal period is to extend the terms of the statute and to read into it matter which Congress did not see fit to insert

In order to determine the meaning of the phrase "most recently accumulated undivided profits or surplus" resort should be had in the first instance to the meaning given to these terms in common speech.

Respondents argue that the terms "accumulated undivided profits or surplus" have a well settled signification in business accounting and mean the "undivided profits or surplus account" as it existed at the close of the last fiscal period. In

this technical sense, it is urged, no profits become "undivided profits" or "surplus" until they have been set aside at the end of an accounting period and allocated to certain accounts known as the "undivided profits" or "surplus" accounts. The word "surplus" has, however, a well established meaning far broader than this alleged technical meaning of "surplus account," namely, the excess of assets over liabilities and capital stock, and this broader meaning is found in technical works on accounting and has repeatedly been adopted by the Courts. "Surplus" is defined by Webster's New International Dictionary, "* * * as distinguished from the capital stock of a corporation, the excess of net assets over the total value of its shares."

In *Kester, Accounting Theory and Practice,* at page 407, we find:

> Under the corporate form of organization, "surplus" in its broadest sense represents the difference between the net worth of the business and the capital stock issued and outstanding.

In *A. Lowes Dickinson "Accounting Practice and Procedure,"* at page 63, it is stated:

> The term "surplus," which is in quite common use, is better confined to the surplus of assets over liabilities, made up * * * of appropriations for various purposes as well as of the balance of undistributed profit and loss.

Leo Greendlinger in "*Financial and Business Statements*" says:

> By the term surplus is meant the intrinsic value of all the assets of a firm over and above its liabilities and outstanding capital (page 195).

In the *Year Book for 1911* of the American Association of Public Accountants it is said (p. 124):

> Surplus: (*a*) In the restricted sense it means accumulated undivided profits.
>
> (*b*) When used in the ordinary sense in a financial statement, it means excess of assets over liabilities and capital. In this sense surplus may include gains arising from acquisition of assets not derived from the ordinary operation of the business. If the excess of assets equals the capital there is no surplus, the capital just balancing the excess or net worth of the business.

In "*Accountants' Reports,*" by W. H. Bell, it is said, at page 60:

> *Surplus:* While the word "surplus" literally denotes the excess of assets over liabilities and original capital, when employed without explanation of its composition, it is usually intended to, and in fact should mean earned surplus, as distinguished from capital or special surplus.

And similar definitions have been adopted by the Courts: Thus in *Fidelity Trust Co., etc.,* v. *The*

Board of Equalization, etc, 77 N. J. L. 128, at page 130:

> In order to ascertain the capital and surplus it is necessary to find the true value of the gross assets. From this must be deducted debts and liabilities, the remainder will be the value of the capital and surplus, if any.

In *People ex rel., etc.,* v. *The Board of Commissioners, etc.,* 76 N. Y. 64, it is said at page 74:

> " Surplus " earnings is an amount owned by the company over and above the capital and actual liabilities, * * *.

In *Leather Mfrs. Nat. Bank* v. *Treat,* 116 Fed. 774 (Aff. 128 Fed. 262), at page 775, Lacombe, C. J., defined surplus—

> in its natural and ordinary sense as including the entire overplus of assets over liabilities.

In *Anderson* v. *Farmer's Loan & Trust Co.,* 241 Fed. 322, at pp. 326–327, this Court said:

> * * * the words " capital, surplus, and undivided profits " relate to no particular kind of property but are expressions describing the amount of the residue of the assets after the liabilities have been deducted.

This last definition of " surplus " is adopted by the Court below (p. 104).

Thus even among accountants the term " surplus " is not limited to " surplus accounts " in the sense used by the court below, but is synonymous

with any excess of net assets over capital stock, whether such excess is made up of undistributed current earnings or of earnings of preceding fiscal periods, which have been placed in the so-called "surplus" account. Even if modified by the word "accumulated," the word "surplus" has no different signification, the word "accumulated" meaning simply "heaped up," "collected," or "brought together," "amassed," and it was unmistakably used by Congress in this sense in Section 201 (*e*) of the Revenue Act of 1918 and Section 201 (*f*) of the Revenue Act of 1921.

Congress, however, did not limit itself to the phrase "surplus" or "accumulated surplus," but in order to reach distributions from earnings on hand it used the words "accumulated undivided profits or surplus." If on a narrow construction of the term "surplus" it might be contended that it does not include the earnings for the current fiscal period, this construction is inapplicable to the term "profits" or "accumulated undivided profits." The word "profits" is one in common use, unambiguous, and primarily means "pecuniary gain" in any business, transactions, or investments, or excess "of sale price over cost."

The learned Court below does not apparently differ with this definition of "undivided profits." The Court says (p. 104):

> It (the term "undivided profits") means such profits as exist and have or have not been ascertained, but, in any event, have not

> been distributed or otherwise used, and is distinguishable from current earnings or profits.

The last statement, that the term is distinguishable from current profits, is added without explanation and is in reality inconsistent with the preceding statement, namely, that undivided profits are "such profits as exist and have or have not been ascertained, but, in any event, have not been distributed." A better definition of current earnings can not be conceived.

In Section 207 of the 1917 Act Congress in defining "invested capital" again used the phrase "undivided profits," and its use in this connection is strong evidence of the manner in which it was used in Section 31 (*b*). Section 207 specifies what assets may be recognized in calculating the invested capital of a partnership or corporation for excess profits tax purposes, and provides that it shall include "(3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year," 40 Stat. 306. As so used, "undivided profits" can mean nothing but current earnings of the taxable year. This phrase is repeated in Section 326 of the Revenue Act of 1918, 40 Stat. 1092, and again in Section 326 of the Revenue Act of 1921, 42 Stat. 274. By qualifying the term "undivided profits" in this section with the clause "exclusive of undivided profits earned during the taxable year" Congress plainly disclosed its intent

to use the term "undivided profits" so as to include therein the current earnings for the taxable year. If "undivided profits" referred only to those amounts which had been set over into a "surplus account" or an "undivided-profits account" at the close of any particular fiscal year, then the modifying and qualifying clause contained in Section 207 would have been unnecessary.

The foregoing provision makes it clear that Congress regarded current earnings as "surplus or undivided profits," and that in using such term Congress had not in mind any segregation of profits of previous years to the exclusion of current earnings, but used these words in their common signification of any excess of assets over liabilities including capital stock, and of profits on hand and undistributed, no matter when acquired. "A word or phrase repeated in a statute will bear the same meaning throughout the statute, unless a different intention appears." *Lewis Sutherland's Statutory Construction*, Vol. II, 2nd Ed., page 758. No different intention appearing, the phrase "undivided profits" must be taken to mean the same in Section 1211 as it does in Section 207 of the Act of October 3, 1917, and to include earnings and profits for the current fiscal period.

Literally therefore surplus and undivided profits embrace current earnings. Such earnings are part of the surplus on hand at any time, and since they have been most recently acquired are the most recently accumulated surplus. In order to

exclude them it is necessary to read "surplus," not in its ordinary sense of excess of assets over liabilities and capital stock, but in the very special sense of "surplus *account.*" This involves an extension of the terms of the statute. In the same way in order to exclude earnings from "undivided profits" it is necessary to construe this term not as "profits which exist and have or have not been ascertained, but in any event have not been distributed," but as such profits as have been ascertained by a balancing of the books and the closing of the same into an undivided profits account.

The Court below relies upon the use of the words "earnings and profits" six times in Section 31 (*a*) and (*b*) and the use of the phrase "undivided profits or surplus" when the tax rate is prescribed. It holds that the words "earnings and profits" includes current earnings and that had Congress intended to allocate dividends first to current earnings it would have used the phrase "most recently accumulated earnings and profits." In other words, the Court holds that Congress intended to contrast undivided profits or surplus with earnings and profits, and by making this distinction to exclude current earnings as a fund to which dividends should be allocated.

To demonstrate that no such distinction was intended it is only necessary to refer to the following provisions of Section 31 (*b*):

> * * * Nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made.

Here Congress used the words "earnings and profits" instead of "undivided profits or surplus," but it is clear that it did not use them as contrasted with "undivided profits or surplus," but only in a more limited sense, exactly analogous to the term "undivided profits." The absolute rule of law which is here laid down prohibits the distribution of earnings and profits accrued prior to March 1, 1913, until after there has been distribution of all earnings and profits accrued since.

This is a positive prohibition which includes not only earnings set over into a surplus account or an undivided profits account, but also earnings and profits accrued during the current fiscal period. No narrower construction of these words is possible nor is a narrower construction claimed by the Court below. Current earnings must be distributed before there can be a distribution of earnings and profits accumulated prior to March 1, 1913. Consequently if all the surplus accumulated between March 1, 1913, and the close of the last fiscal period has been distributed, but the corporation has on

hand current earnings it can not distribute its March 1, 1913, surplus tax free until it has distributed its current earnings. But if it distributes its current earnings at what rate shall they be taxed? To say that they are tax free is directly to disobey the provisions of the statute that no tax free distributions shall be made under such circumstances. On the other hand, to say that such distributions are taxable at 1917 rates is to admit that under certain circumstances current earnings may be the most recently accumulated surplus or undivided profits.

The contention that the term "accumulated undivided profits or surplus" was used to the exclusion of current earnings and profits, thus leads to a manifest absurdity which will not permit of rational solution and which it can not be supposed that Congress intended. It is only when "undivided profits or surplus" is read as a broader term including "earnings and profits" (and current earnings and profits as well) that the section becomes clear and consistent. It then lays down a perfectly sensible rule, namely, that a corporation must first distribute its current earnings, which are taxable at the rates prescribed for the year in which the distribution is made; it may then distribute the earnings for the last fiscal period and so on back to March 1, 1913, each distribution being taxable at the rate in force at the time the earnings distributed accrued. When all earnings accrued since March 1, 1913, have been distributed,

then tax-free distributions may be made. If the term "accumulated undivided profits or surplus" is held to include "earnings and profits," the statute becomes clear and consistent and the obvious intention of Congress will be effected. Dividends will be "deemed" to have been paid from the most recently acquired earnings lawfully applicable thereto—the literal meaning of the words expressing the Congressional intent.

Point IV

The construction of Section 31 (b) adopted by the learned Court below leads to absurd results and produces inequalities and injustices among taxpayers. It should not be upheld since another and more reasonable interpretation is present in its terms

It is a cardinal rule of construction frequently recognized by the Court that statutes are to be construed so that unjust and absurd results will be avoided.

> Nothing is better settled than that statutes should receive a sensible construction, such as will effectuate the legislative intention, and, if possible, so as to avoid an unjust or an absurd conclusion.
>
> *Lau Ow Bew* v. *United States,* 144 U. S. 47 at p. 59.

> We are, therefore, bound to give heed to the rule that where a particular construction of a statute will occasion great inconvenience or produce inequalities and injustice, that view is to be avoided if another and

more reasonable interpretation is present in the statute.

Knowlton v. *Moore,* 178 U. S. 41 at p. 77.

In the argument under the preceding point some of the absurd results of the construction of Section 31 (*b*) adopted by the Court below have been touched on. To hold that the term " most recently accumulated undivided profits or surplus " is to be given a special and a technical meaning and that it includes only amounts which have been set over at the end of a fiscal period into a surplus account or an undivided profits account leads to discriminations and inequalities, which Congress must have had in mind and which it can not be presumed to have intended. It is well recognized that some corporations carry over into their surplus account at the end of each month their earnings for the month; with others the practice is to carry the amounts over at the end of each quarter; still others close their books semiannually. If such corporations should have made distributions in September and December, 1917, as did the Phelps Dodge Corporation, then there would have been included in such distributions earnings accrued in 1917. The dividends, to the extent that they represented surplus accumulated in 1917, would have been taxable at 1917 rates. Did Congress intend that the rate at which dividends are taxed should depend upon the way that the corporations, from which dividends are received, keep their books? If it did, it certainly made the rate of taxation of

individuals and the amount of revenue collected depend upon an arbitrary and very trivial circumstance.

Suppose four corporations engaged in the same line of business, earning exactly the same amounts and making the same distributions to their stockholders in 1917. The first closes its books monthly; the second, quarterly; the third, semiannually; the fourth, annually. Although the actual facts are the same in each case, yet under the construction adopted by the Court below the rates at which the stockholders are taxed will vary enormously, depending upon a circumstance over which they have no control, and which furnishes no ground for making any distinction.

The argument of the Court below that in allocating dividends to the "surplus or undivided profits accounts" Congress intended that such account should be determined exclusively on an annual basis will not hold. The statute says nothing about how the surplus and undivided profits shall be determined nor is there authority for reading such a proviso into it. The fiscal period of a business is by no means always the year. It is often much shorter, depending upon the needs of the business. (See *Kester, Accounting Theory and Practise,* 2nd Ed., Vol. 1, page 48.) There is no reason to suppose that because the Act contemplates an annual system of taxation it must have contemplated an annual closing of books. Furthermore, even if we imagine that it did, the

inequalities pointed out would prevail in the case of corporations whose fiscal years closed in the earlier months of the year. In such cases with the same earnings and the same distributions stockholders of corporations, which ended their fiscal year in April, July, or October, would be taxed at far higher rates than stockholders in corporations, the fiscal year of which is the same as the calendar year.

It is not an answer to this argument to say that in the latter case the tax would only be postponed and that if the Revenue Act of 1917 had continued in force distributions in 1918 would have been taxed at 1917 rates. The fact remains that in 1917 stockholders in different corporations making the same earnings and paying the same amount in dividends would be taxed at widely different rates, depending upon the bookkeeping methods of the corporation. This is a result which Congress could not have intended. As is well said by the Court below in regard to the other aspect of this case (p. 97):

> * * * but it is well at the outset to realize that, in this case, the rights of the parties can neither be established nor impaired by the bookkeeping methods employed or by the names given to the various items.

Or to adopt the language of the learned District Court (p. 20):

> It seems to me that the Congressional intent is clear. Distributions to shareholders

> are to be regarded as made from current earnings and the most recently accumulated surplus. Congress, in my judgment, did not intend to lay down a narrow rule to be whittled away by technical definitions of the terms surplus, undivided profits, dividends, and distributions. Nor did it intend to recite a mere prima facie rule which could be arbitrarily set aside by the form of the bookkeeping entries. It is to be assumed that Congress desired that, so far as possible, the tax should be regulated by the substance of things and not their form, and that taxation should not fall more lightly upon one man than upon another because of ingenuity in bookkeeping methods.

For other cases holding that taxation must be based upon the facts and not upon bookkeeping methods, see:

Southern Pacific Co. v. *Lowe*, 247 U. S. 330.

Leather M'f'rs. Nat. Bank v. *Treat*, 128 Fed. 262, at page 265.

Baldwin Locomotive Works v. *McCoach*, 215 Fed. 967 (aff. 221 Fed. 59).

Industrial Trust Co. v. *Walsh*, 222 Fed. 437.

Forty Fort Coal Co. v. *Kirkendall*, 233 Fed. 704.

Anderson v. *Farmers' Loan & Trust Co.*, 241 Fed. 322, 328.

If it be supposed, as was the case with many corporations, that on December 31, 1916, the corpora-

tion had no surplus, and if it be supposed that as a result of the war the corporation made large profits in 1917, which it distributed to its stockholders in that year, under the construction of this section by the Court below would such a distribution be tax free? If not, at what rate would it be taxed? If the answer is at 1917 rates, is it conceivable that Congress intended that the tax rates on individuals should vary according to the previous financial condition of the corporation? Suppose—again a very common case—that the corporation was not organized until 1917 and was created for the sole purpose of engaging in some form of profitable war work; suppose that it made large profits in 1917, which it distributed to its stockholders in that year. According to the Court below, would these distributions be tax free? If not, would they be taxed at 1917 rates?

If the answer to these questions is that the distribution would be tax free, the result is so absurd and so contrary to the manifest intention of Congress as disclosed by the circumstances attending the enactment of the statute that a construction requiring such an answer is untenable on its face.

The Court below did not give a direct answer to the case just put. The reason is that it can not be answered. The suggestion that the tax is only postponed is surely not an answer, since by hypothesis the earnings for the year are distributed in 1917, and consequently no distribution of the same in 1918 could possibly be made. If such dis-

tribution could be made tax free a corporation in the situation outlined above could, by continuing to make annual distribution of its earnings, effectually prevent the imposition of a tax upon its stockholders, a result which could not have been in contemplation of Congress.

If, on the other hand, the answer to the above questions is that the distributions should be taxed at 1917 rates, then it is apparent that the words "most recently accumulated undivided profits or surplus" of a corporation do or may include current earnings and that the construction of this phrase by the Court below is erroneous.

It is likewise fundamental that a statute is to be interpreted according to the intention of the legislature apparent on its face. *Wilkinson* v. *Leland*, 2 Pet. 627. The intention apparent on the face of this act is that distributions should first be made out of 1917 earnings so far as they will go, and be taxable at 1917 rates, no matter when, or how often, the books of the corporation are closed. When these are exhausted, distribution may be made from 1916 surplus, and so on. It certainly was not the intention of Congress that all distribution made in 1917 should be taxed at 1916 rates or lower, if perchance the corporation had a surplus on its books at the close of its last fiscal period; that, with the exigencies of the war requiring that every available source of revenue should be drawn upon, distribution by such corporations should bear the comparatively low rates prescribed by the 1916 or some earlier

Act; that the man who earned his income in that year should pay a normal tax of 4 per cent and surtaxes as high as 63 per cent, whereas the man who derived his income from dividends should pay surtaxes of only 13 per cent at the highest. The Court is bound to give effect to the manifest intention of Congress if it is possible so to do. Here the language of the section if construed in its ordinary and literal sense will effectuate this intention. To go beyond leads only to confusion.

Point V

The construction of Section 31 (b) adopted by the learned Court below disregards the long-continued construction of this section by Treasury officials, taxpayers, and corporations alike

The Court below in its opinion discusses at length whether dividends are ordinarily paid out of current earnings and, concluding that they are not, advances this as a reason against the Government's construction of Section 31 (*b*). It is submitted that this question has no bearing whatever upon the construction of this section. As pointed out above, Section 31 (*b*) deals only with the question, at what rates shall certain forms of income received by an individual be taxed? Section 31 (*b*) is not directed to corporations or directors and does not attempt to prescribe how or in what manner dividends shall be declared or to what fund they shall be charged on the books. The section lays down the rule in regard to the taxation of individuals on certain kinds of

income received in the year 1917, and it is not perceived how the fact that some of the larger and wealthier corporations of the country can not ascertain their annual earnings until after the closing of their books at the end of a fiscal period has any bearing on how an individual receiving a distribution from such a corporation should be taxed.

If the question is at all relevant, it is submitted that to determine the construction of a section of a revenue act addressed to the country as a whole by the accounting practice of a comparatively small number of large corporations is to commit the fallacy of generalizing the particular. The vast majority of corporations know accurately at any time the amount of profits that have been made and govern their distributions accordingly. Even large corporations, like Phelps Dodge Corporation, can by trial balance, or other appropriate accounting method, determine the amount of their current earnings with a fair degree of accuracy. The close correspondence between earnings and distributions of Phelps Dodge Corporation in the years 1916 and 1917 shows that the directors were fully aware of the condition of the corporation during the year.

That there is no essential absurdity in speaking of a corporation distributing its earnings in a particular year appears from the fact that Congress in the 1918 and 1921 Acts expressly recognized that distributions could be and commonly were made out of current earnings.

Strong proof that the fair meaning of the words surplus or undivided profits in the statute includes current earnings is found in the fact that contemporaneous construction by taxpayers, corporations, and taxing officials agreed in so holding. If the construction of the Court below is correct, none of the regular dividends declared by Phelps-Dodge Corporation was taxable to the stockholders at 1917 rates. Yet Dr. Douglas returned all his regular dividends except the first (which the corporation had said was out of 1916 surplus) for taxation at 1917 rates (p. 75). The corporation itself ruled that all regular dividends except the first were out of 1917 earnings (p. 55).

Furthermore, in making up its excess profits tax return for 1917, the corporation did not reduce its invested capital (p. 35) by the amount of any of its dividends (including the depletion dividends), which it should have done had they all been paid out of 1916 surplus, since by Section 207 the invested capital must be averaged monthly and if the surplus going into invested capital is reduced for any reason, allowance must be made for such reduction in subsequent months.

The argument that Dr. Douglas and the corporation were coerced by the regulations of the Treasury Department into adopting this practice is not impressive. Paragraph 26 of Regulations 33, Revised, issued under the Revenue Act of 1917 (page 8), covering distributions from depletion reserves, clearly provided that no distribution would be

deemed to have been made from such a reserve except to the extent that it exceeded the surplus or undivided profits of the corporation at the time of such distribution. This paragraph was as precise as Article 107 hereinafter set forth, yet Dr. Douglas and Phelps-Dodge Corporation found no difficulty in attempting to assert freedom from taxation for the so-called depletion dividends notwithstanding the fact that the corporation had on hand surplus or undivided profits many times the amount of such dividends.

Article 107 of Regulations 33, Revised, pp. 61-62, was issued to give effect to Section 31 (*b*) of the Act of 1917, and is as follows:

> Any distribution made to shareholders in the year 1917 or subsequent years (except any distribution of dividends made prior to Aug. 6, 1917, out of earnings or profits accrued prior to Mar. 1, 1913) shall be deemed to have been made from the most recently accumulated undivided surplus or profits, and shall constitute income of the distributee for the year in which received, and shall be taxed to such distributee at the rates prescribed by law for the years in which such surplus or profits were earned by the distributing corporation.
>
> Thus, if a corporation distributed dividends in 1917 such dividends will be deemed to have been paid from the earnings of 1917, and the recipient, if an individual, will be liable to additional tax, if any, and if a corporation, to income tax, at the rates for the

> year 1917, unless it is shown to the satisfaction of the Commissioner of Internal Revenue that at the time such dividends were paid, the earnings up to that time were not sufficient to cover the distribution, in which case the excess over the earnings of the taxable year will be deemed to have been paid from the most recently accumulated surplus of prior years, and will be taxed at the rate or rates for the year or years in which earned.
>
> A corporation declaring and paying dividends out of a surplus or earnings accumulated over a period of years should make a record in its books of the amount of dividends paid out of each year's undistributed surplus or profits, and advise the stockholders accordingly, in order that the dividends received by them may be taxed at the respective rates prevailing during the years in which the surplus or profits so distributed were earned * * *.

This regulation has been followed by numerous Treasury decisions and rulings amplifying and explaining it, and never at any time has there been any ruling or practice of the Bureau of Internal Revenue inconsistent with this regulation. The contemporaneous and practical construction placed on the statute by the Bureau of Internal Revenue has been uniform and consistent, both in published decisions and in practice, and it is submitted that such construction "ought not to be overruled without cogent reasons."

United States v. *Moore,* 95 U. S. 760, at page 763.

The construction here contended for was sustained contemporaneously, but independently by the District Court (Judge Mack), in the case at bar (287 Fed. 919) and by the United States District Court for the Northern District of New York (Judge Cooper) in the case of *Harder* v. *Irwin,* 285 Fed. 402. It was also applied by the United States District Court for the Eastern District of Pennsylvania (Judge McKeehan) in the case of *Miller* v. *Lederer* (not yet reported, decided August 19, 1924).

It should be noted also that in the case at bar the issue here presented was not raised by the pleadings for at the time this action was brought it had apparently never occurred to respondents. Furthermore, there is no apparent reason for the rule. Why Congress, under the most urgent need of drawing upon all available sources of revenue in order to carry on the war should have decided to forego one of the largest and most fruitful sources; why it should have decided to discriminate so greatly in favor of income derived from dividends as opposed to income derived from interest, rents, or personal efforts; why it should have decided to tax at a lower rate, or to leave practically untaxed, the large war profits coming to individuals through dividends declared and paid in 1917, the Court below does not pretend to say. The suggestion of respondents that it was intended to leave these

profits free for investment in Liberty Bonds would apply equally to all other forms of income and certainly does not furnish a reason for the extraordinary tenderness which Congress is supposed to have shown to recipients of dividends. In default of such a reason Section 31 (*b*) should receive the sensible construction here contended for, the only construction which is consistent with all its provisions, with the obvious intention of Congress and with fairness to taxpayers of all kinds.

CONCLUSION

For the foregoing reasons the judgment of the Circuit Court of Appeals for the Second Circuit is erroneous and should be reversed and the judgment of the District Court reinstated.

Respectfully submitted.

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Special Assistants to the Attorney General.

MARCH, 1925.

O

In the Supreme Court of the United States

OCTOBER TERM, 1924

WILLIAM H. EDWARDS, COLLECTOR OF INTERNAL REVENUE, petitioner
v.
ARCHIBALD DOUGLAS, GEORGE NOTMAN, AND EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased

No. 524

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

I

Respondents' brief and the briefs submitted *amici curiae* exhibit a conception of the scope and effect of Section 31 (*b*) of the Revenue Act of 1917, in sharp contrast to the broad language used. On its face Section 31 (*b*) lays down a general rule of taxation of all distributions made by all corporations to their shareholders in the year 1917, and in treating of the subject of the Section uses the general language of Section 31 (*a*).

Section 31 (*a*) lays down a general definition of dividends as " any distribution made or ordered to

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be made by a corporation * * * out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders * * *."

Section 31 (*b*) lays down rules for the taxation of "Any distribution made to the shareholders * * * of a corporation * * * in the year nineteen hundred and seventeen, or subsequent tax years * * *."

The scope of Section 31 (*b*), therefore, is as broad as the scope of Section 31 (*a*), and it is clear from the language used that it was intended to apply to every distribution which was covered by the definition of dividends in Section 31 (*a*).

In the view of respondents, however, the primary purpose of Section 31 (*b*) is not to lay down a general rule in regard to the taxation of all dividends, but to apply only to distributions of a limited class of corporations, namely, those corporations which at the beginning of the year had an undivided profits or surplus account upon their books, leaving distributions by other corporations to be taxed at the rates prescribed for other income. (See respondent's brief, p. 52; brief of Messrs. Murray & Tweed, p. 18; brief of Mr. George E. Holmes, p. 12.)

This construction reads into the section a qualifying clause, and is inconsistent with the broad language used and with the relation of the section to Section 31 (*a*). It is negatived by the fact that every other part, except the last sentence, pur-

ports to lay down a general rule of taxation, and in the last sentence, in which an exception is admittedly made, specific words of exclusion are used.

If, as seems plain, Congress in Section 31 (*b*) intended to lay down a general rule for the taxation of all distributions, which could be subject to tax, it is to be presumed that the language used must be such as is applicable to all such distributions. Since distributions out of current earnings are lawful and customary, the only meaning of the words, "most recently accumulated undivided profits or surplus," which could apply to distributions by every corporation is one in which current earnings are embraced. By this construction the natural and literal meaning of these words is preserved and the section becomes one of universal application, which it unquestionably was intended to be.

II

The legislative history of Section 31 (*b*), set forth at such length in respondents' brief, confirms the assertion made in the main brief for petitioner that nothing can be found in the Congressional Record which in any way exhibits an intention on the part of the Conference Committee to change the meaning attempted to be expressed in the Senate draft of the bill. Attention is particularly called to the remarks of Senator Simmons, quoted at page 16 of respondents' brief. The Senate bill was adopted on September 10, 1917, and the Conference Committee's bill was reported to the Sen-

ate (Cong. Rec., vol. 55, part 8, p. 7606, 65th Cong., 1st sess.), and was passed by both Houses on October 2d, 1917. The remarks of Senator Simmons were made on the same day. If, as respondents say, these remarks are an accurate synopsis of the bill as passed by the Senate, and the bill was radically changed by the Conference Committee, why should the Senator have referred only to the discarded bill and failed to mention the change by the Conference Committee?

Much is made in all the briefs of the so-called proviso added by the Conference Committee to Section 31 (*b*), reading:

> * * * nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed * * * exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made.

It is argued that this proviso is surplusage under the Government's construction of Section 31 (*b*), and it is pointed out that it did not appear in the Senate drafts, the inference being that its insertion by the Conference Committee was due to the fact that the purpose attempted to be expressed by the Senate drafts had been changed. No such inference can be drawn. Under any construction of Section 31 (*b*) in its present form this proviso is necessary. Since the section provides for the taxation of distributions at the rates prescribed for

the *years* in which the surplus or profits from which they were made were accumulated, it might possibly have been held that earnings for the months of January and February, 1913, were to be taxed at 1913 rates. Under the original Senate theory that distributions were to constitute part of the income of the distributee for the year in which the surplus thereby distributed was earned by the corporation, it was unnecessary, since income received in January and February, 1913, could not constitutionally be taxed. When distributions were held to be income for the year in which *received,* the possibility of the taxation of earnings accrued prior to March 1, 1913, arose, and an express assertion of policy in regard to such earnings became necessary.

This assertion was made in the clause that earnings accrued prior to March 1, 1913, could be distributed exempt from the tax after the distribution of earnings and profits accrued since that date had been made. This removed any question which might have arisen from the fact that Section 31 (*a*) had been enacted in substantially the same form as the proviso in Section 2 of the Revenue Act of 1916, under which it had been held that earnings accrued prior to March 1, 1913, could be distributed tax free even though earnings accrued since that date remained undistributed. It also put at rest any possible doubt that the 1916 law had been changed and at the same time clarified the meaning of Section 31 (*b*). Respondents do not reconcile this clause with their construction of the words,

"most recently accumulated undivided profits or surplus." It is argued, however, in the brief submitted by Mr. George E. Holmes that the purpose of this clause was to allocate distributions to 1917 earnings and to tax them at 1917 rates after distribution had been made of 1916, 1915, 1914, December 31, 1913, surplus in the order named. But if it was intended to prescribe such an unnatural order of allocation, why was it not done in so many words? Why was it left to inference from a proviso to a proviso? This is an example of the fantastic readings of the section which must be indulged in, if the natural and literal meaning of "undivided profits or surplus" is departed from and a narrow construction of these terms is adopted.

III

The taxpayers base their construction of Section 31 (*b*) largely on the unsupported assertion that dividends are not commonly declared out of current earnings, but only out of the surplus on the books at the beginning of the fiscal period. (Respondent's brief, pages 28–38; Brief of Messrs. Murray and Tweed, pages 5–6.) It is assumed that directors do not and can not know what are the current earnings at any one time in the intermediate course of the year. The answer to this argument may be found in the financial pages of any newspaper or in the files of any recognized financial journal. Even the largest corporations are constantly issuing statements showing their semiannual, quar-

terly, and monthly earnings. These statements are frequently accompanied by comments of officers as to whether dividend requirements have been met. A common expression found in financial items is that the "quarterly dividend has been earned." Furthermore, surplus earned in prior years is often permanently invested in fixed assets, whereas current earnings may be found in cash or in liquid assets capable of distribution, and in many cases corporations *must* look to their current earnings if any distribution is to be made.

Indeed it is unnecessary to go beyond the record in the present case to show that dividends are paid out of current earnings. In 1915 the Phelps Dodge corporation earned $5,623,523.89 (p. 24). In 1916 it distributed $14,625,000. Its earnings for that year were $17,750,621.67. In 1917 its earnings were $16,742,487.06, and its distributions $14,400,000. In its statement to stockholders it speaks of its "regular dividends and extras" (p. 55) declared and paid in 1917. "Extra" dividends, it is well known, are dividends declared and paid when earnings are high and are earmarked as such in order that stockholders may realize that they are paid solely on account of high earnings and are not to be considered as part of the regular dividend policy of the company.

That dividends may be and commonly are declared and paid out of current earnings has been

recognized by this Court. In *Lynch* v. *Hornby*, 247 U. S. 339, this Court, at page 344, said:

> Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation.

IV

It is also suggested that a declaration of dividends out of current earnings is illegal under State laws forbidding the declaration of dividends except from "surplus profits." (Respondent's brief, page 38.)

If during the year a corporation makes a profit on a particular transaction, and its capital is unimpaired, the amount of this profit is surplus. It may not appear in the so-called surplus *account* of the corporation, if there is one. It may be in its "cash" account or "earnings" account or some other account. As long as it is retained by the company it is surplus and also an undivided profit in the exact and literal meaning of this term. If the corporation continues to operate at a profit it acquires or accumulates further surplus, which, as admitted by the court below (p. 105), is literally its most recently accumulated undivided profits

or surplus. This surplus is legally as available for distribution to stockholders as the surplus account, if any, standing on the books. If the company wishes to make a distribution to its shareholders it may lawfully distribute up to the amount of any surplus standing on its books, plus the amount of any surplus acquired since the books were closed, subject to the provision that such distribution be made in good faith, and that reasonable provision be made to take care of future liabilities. This is all that is held by *People ex rel Jamaica Water Supply Co.* v. *State Board of Tax Commissioners,* 128 App. Div. (N. Y.), 13, cited by respondents at page 38 of their brief, and it is unquestionably correct. How the corporation treats this distribution on its books is not material; certainly not under a statute providing that all distributions must be deemed to have been made from the most recently accumulated surplus. Under this language the distribution must clearly be allocated to the most recently acquired earnings.

V

It is argued by respondents, as well as by the court below (respondents' brief, pages 30–34), that because a corporation, like Phelps Dodge Corporation, is required to take inventories at the beginning and the end of the year in order to determine its *net income* for that year for income-tax purposes, any earnings in the intermediate course of a year are only prospective earnings. This argument

is fallacious, and this fallacy pervades a good part of the brief for respondents. The distinction between statutory net income and actual corporate earnings has already been pointed out. It has likewise been shown that because the statute imposes a tax on an annual net income there is no reason to suppose that it contemplates an annual closing of books or prescribes an annual fiscal period. A corporation may close its books as often as its business needs require, for aught that appears in the Revenue Acts. It is required only that in computing net income for the purpose of taxation the gross income and the deductions shall be determined on an annual basis. But this does not affect the question whether a corporation has earnings at any one time. If, for instance, Phelps Dodge Corporation sold 1,000,000 pounds of copper on July 1, 1917, at 10 cents a pound over the cost of production, on that date it had a profit of $100,000, which profit was surplus available for dividends.

The case is the same as the case of a corporation owning only one piece of realty, which it sold at a profit of $100,000, as to which there could be no dispute. The fact that due to a fall in the market price of copper the closing inventory as of December 31, 1917, may be so low that the net income for the year may be greatly reduced or completely wiped out does not mean that this profit has in some way or other been retroactively destroyed so that on July 1st it was not a profit. It would be just as sensible to say that profits earned in the previous

year had been wiped out. What has happened is that a subsequent loss has reduced the annual net income in the way that a subsequent fire or mine disaster might do.

No more does the fact that the corporation balances its books at stated intervals have any relevancy. Whether profits exist at any time is a question of fact whether or not the corporation has closed its books. If a subsequent loss takes place before the books are closed, this does not make a distribution of profits which actually existed a distribution of capital, or a tax on such distribution a tax on capital.

VI

In an attempt to avoid the absurdities and inequalities inherent in their construction of the statute, respondents and the *amici curiae* both argue that the high war taxes on the supposed favored class of taxpayers are not taken off, but only postponed. It is argued (Respondents' Brief, page 61) that this postponement was only until January 1, 1918, three months after the Act was passed, despite the fact that the tax on distributions made in January, 1918, would not be due until June, 1919. It is also argued (Respondents' Brief, page 69) that if the Revenue Act of 1917 had continued in force when the tax rate came to be reduced, these taxpayers would still be paying the high rate. But this is to pile inequality on inequality, and to impute to Congress the capricious

and unreasonable intention of imposing pre-war rates when war rates were required, and war rates when the same were no longer necessary. There is no reason for such discrimination. To refrain from imposing war rates on distributions by corporations which had no war profits, and therefore must be distributing pre-war earnings, might appeal to the congressional sense of fairness in view of the disturbed condition of business in 1917. But to discriminate between taxpayers according to the previous financial condition of corporations making war profits and paying distributions is utterly unreasonable and absurd.

VII

Instances are cited (Respondent's Brief, pages 29, 30, 36–39) in which the words "surplus" and "undivided profits" are used in the sense of "surplus account," and "undivided profits account." It is not denied that these words may be used in this sense when the context requires it or when the word "account" is added. It is denied that this is the well-settled or only meaning, or that in strict accounting parlance "the most recently accumulated undivided profits or surplus" are not literally the most recent current earnings.

In particular the explanation (Respondent's Brief, pages 39–41; Brief of Messrs. Murray and Tweed, pages 16, 17) of the clause in Section 207 (*a*) of the Revenue Act of 1917, excluding from paid-in or earned surplus and undivided profits used or

employed in the business "undivided profits earned during the taxable year," as intended to exclude only such undivided profits as come into existence at the end of the taxable year, overlooks the use of the word "earned," and the provision that invested capital must be "averaged monthly." If only undivided profits appearing on the books at the close of the taxable year were intended, it would have been sufficient to say "exclusive of undivided profits of the year." Furthermore, there would be no reason for the exclusion, since only surplus and undivided profits *used or employed* in the business were included. The only undivided profits earned during the taxable year which could be used or employed in the business during the year were the current earnings, and not the undivided profits appearing at the end of the year, and it is clear that it was such earnings that Congress had in mind when it used the phrase "undivided profits."

VIII

It is stated at page 69 of respondent's brief that if the government had adopted the construction of Section 31 (*b*), for which respondents contend, it would have secured greatly increased excess-profits taxes from corporations. This is true and shows the importance of the rule that in determining the meaning of a statute the construction of the executive department charged with its enforcement will be given great weight. The Treasury Department had the duty of determining in the first instance

which construction of Section 31 (*b*) should be adopted. One construction would have increased the income taxes of stockholders, the other the excess-profits taxes of corporations. The department adopted the first construction, and thousands of corporations (including Phelps Dodge Corporation) received the benefit by the adjustment and closing of their excess-profits tax returns upon this basis. Many millions of dollars of taxes were collected and refunded under this construction.

Many years after the tax became due, and after the statute of limitations on the collection and refund of taxes has expired, this Court is asked to set aside the departmental construction in the interest of one class of taxpayers. It is clear that in a case like this the construction should not be overruled unless it is entirely unwarranted by the words of the statute.

This case is analogous to *Lincoln Chemical Co.* v. *Edwards*, 289 Fed. 458, in which a departmental construction of the Revenue Act of 1917 favorable to one class of taxpayers was contested by a taxpayer adversely affected thereby. The same court which heard the case at bar below at page 462 said:

> The construction given to an Act of Congress by a department of the government charged with its execution, is not controlling upon the courts as the department is not authorized to exercise the judicial function, but it is entitled to great consideration when the meaning of a statute is doubtful. *United States* v. *Hermanos y Compania*, 209 U. S.

337, 339; *United States* v. *Healey,* 160 U. S. 136; *Robertson* v. *Downing,* 127 U. S. 607. And the consideration given to such construction is particularly weighty in the case of statutes levying impositions where the construction had been favorable to the persons affected. *State* v. *Orleans Parish Bd. of Assessors,* 52 La. Ann. 223; *Attorney General* v. *Newborn,* 21 N. C. 216.

It is submitted that this rule is particularly applicable to the case at bar. The construction adopted by the Treasury Department has been favorable to a large class of taxpayers. It should not be overruled unless it is clear that the contrary construction would be sustained against the objection of taxpayers adversely affected thereby, and unless it is clear that the departmental construction is clearly contrary to the intention of Congress.

CONCLUSION

For the above reasons the judgment of the Circuit Court of Appeals for the Second Circuit should be reversed and the judgment of the District Court reinstated.

Respectfully submitted.

JAMES M. BECK,
Solicitor General.
ALFRED A. WHEAT,
RICHARD S. HOLMES,
Special Assistants to the Attorney General.

APRIL, 1925.

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In the Supreme Court of the United States

OCTOBER TERM, 1925

No. 129

WILLIAM H. EDWARDS, COLLECTOR OF INTERNAL REVENUE, petitioner

v.

ARCHIBALD DOUGLAS, GEORGE NOTMAN, AND EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR PETITIONER IN REPLY TO SUPPLEMENTAL BRIEF FILED BY RESPONDENTS BY PERMISSION OF THE COURT

The only question in this case is the rate of tax to be applied to the sum of $328,400, the amount of two dividends received by Dr. Douglas from Phelps Dodge Corporation on September 28th and December 28th, 1917. During the year 1917 the corporation declared and paid in dividends amounts representing 32% of its capital—four regular dividends of 2½% each, one extra dividend of 3½%, one

extra dividend of 5½%, two extra dividends of 2½% each, *and two dividends of 3% and 5%, respectively, Dr. Douglas's share in which are the dividends now under consideration.*

In his annual report to the stockholders dated February 28, 1918, the president of the corporation, confirming a previous statement under date of January 29, 1919, pointed out that the dividend paid in March, 1917, was declared and paid out of the profits accrued during the year 1916 and that the other three regular and extra dividends were paid out of earnings for the year 1917, while the two dividends under consideration were declared to be "a distribution from the reserve for depletion."

Dr. Douglas filed an income-tax return upon the basis of this report (Record p. 75), returning all the other dividends as taxable at the rates for the years in which they had been reported as earned, but claiming that the two dividends now in dispute were not taxable at all inasmuch as they were capital distributions. The Commissioner of Internal Revenue, however, refused to allow these dividends to be exempt from tax, and held them to be taxable at the 1917 rates, because the earnings of the corporation during the year 1917 were beyond question, as is now conceded, sufficient at the time to pay them. The District Court sustained the Commissioner. The Circuit Court of Appeals sustained the District Court to the extent of holding that the dividends could not be regarded as capital

distributions, but differed with the District Court in holding that they were taxable at the 1916 rates. To review the judgment of the Circuit Court of Appeals upon this latter point, the government obtained this writ of certiorari. No cross writ was asked. Therefore the sole question before this court is, Were these dividends, to pay which the corporation had on hand current earnings at the time they were paid, taxable as income of Dr. Douglas at the rates prevailing in the year when he received them, or at the rates prevailing in the year before he received them?

I

Respondents contended at length in their main brief that under Section 31 (b) of the Revenue Act of 1917 dividends may not be allocated to the earnings of the year in which paid for the reason that corporate directors do not know in the intermediate course of the year what the earnings are. It was suggested upon the argument that this supposed difficulty might be overcome if the method of allocation was to the earnings as finally determined at the end of the year, and that dividends, in so far as they did not exceed such earnings, should be taxable at the rates prevailing in the year in which paid, and that only the excess, if any, should be allocated to surplus accumulated in prior years and taxable at the rates then prevailing. This suggested method differs somewhat from the method

adopted by the Treasury Department, which requires allocation to the earnings of the year in which paid unless it can be shown that at the time of payment the earnings were insufficient.

The only question to be decided by the Court in this case is whether Section 31 (b) requires the allocation of dividends to earnings of the year in which paid and taxation of the same at the rates prescribed for that year or whether such allocation must necessarily be to surplus accumulated in some prior year. It is conceded that at the time of making the distributions in question Phelps Dodge Corporation had earnings more than sufficient to pay the same. It is also admitted that its earnings for the year exceeded its distributions by more than $2,000,000. It is therefore immaterial whether the method of allocation should be that adopted by the Treasury Department or that suggested on the argument. If 1917 dividends are to be allocated to 1917 earnings, the distributions here involved are taxable to Dr. Douglas at 1917 rates.

II

It is submitted, however, that the suggested method of allocation is nevertheless allowable under Section 31 (b). The statement of the House Committee, quoted at page 36 of the main brief for petitioner, seems to favor it. There is nothing in the legislative history of this section which in any way negatives it. In referring to this legislative history, respondents again fall into an error which

pervades their main brief. It is stated (Respondents' Supplemental Brief, pp. 4, 5):

> "The net income of the year in which such distribution is made" is necessarily surplus arrived at at the close of the year. Congress, therefore, by eliding all reference to this fund in the bill as passed, conclusively expressed its intention that intermediate distributions made in 1917 should not be so allocated.

The premise of this argument is false, and the conclusion is therefore erroneous. As petitioner has repeatedly pointed out, "net income" of the year "is not necessarily" surplus arrived at at the close of the year. As an illustration of this point, suppose that an investment corporation holding only tax-exempt securities receives an income therefrom during the year of $1,000,000. It has no net income, but it has "surplus arrived at at the end of the year" of $1,000,000. Suppose, again, another corporation having incurred a large income tax for the year 1916 receives through changed business conditions in 1917 an income only barely sufficient to pay the tax. Such a corporation has a "net income," since the tax paid is not allowed as a deduction, but since it has been compelled to pay out all of its 1917 earnings for its 1916 tax, it will have no surplus at the end of the year. Congress by eliding the reference to "net income" from the Senate bill did not exhibit an intention that dividends should not be allocated to surplus at the end

of 1917, but merely eliminated a phrase which in many cases would have defeated its purpose.

III

There is nothing in the context of Section 31 (b) which necessarily precludes the construction that the method of allocation should be by reference to the earnings as finally determined at the close of the year. It must be borne in mind that Section 31 (b) is not addressed to corporations and directors, but to stockholders who are returning their dividends for taxation. It prescribes the rate of tax which they shall pay thereon. If Congress intended that distributions made in 1917 should be taxed at 1917 rates, if the earnings of the corporation for the year were sufficient therefor, it is possible to hold that all distributions up to the amount of the earnings as determined at the close of the year should be taxed at 1917 rates, and that only the excess should bear the lower rates prescribed for some prior year. This is consistent with the scheme of the statute which clearly contemplates that dividends shall be allocated to surplus of prior years only to the extent that such allocation is necessary, and that the profits of the later and higher tax years shall be drawn upon first. The statute is addressed to the individual at the time of computing his tax, and at that time "the most recently accumulated undivided profits or surplus" is the surplus determined at the close of the

preceding year, the year in which the income was received. Furthermore, this method coincides with the accounting practice of a large number of corporations, which do not immediately charge dividends to preexisting surplus but hold them in suspense until the end of the fiscal period when any excess of earnings over distributions is credited to surplus and any excess of distributions over earnings charged against it.

IV

Respondents argue that this method of allocation defeats the manifest purpose of the act to induce directors to declare dividends at lower tax rates. There is obviously no purpose to induce directors of corporations making profits during war years to declare prior surplus at lower tax rates. The whole scheme of Section 31 (b) shows an intention to prevent that very thing. The only directors which the statute may attempt to induce to declare dividends at low tax rates are directors of corporations which were not making profits during the war, who, if the stockholders were compelled to pay war rates, would hesitate to draw upon the surplus accumulated when the tax rate was low in order to pay dividends. It is said that if all dividends are held in suspense, directors and stockholders can not know at the time of declaration to what fund such dividends should be charged or what tax rate they will bear. This is to assume in the case of directors of nonprofit-making corporations gross ignorance

of the affairs of their companies, which can hardly have existed in fact. In the case of other corporations there is no reason why they should not know at the time of declaration. Congress certainly did not intend that distributions should be made only when it was apparent that the stockholders would not have to pay the regular rates thereon.

V

There is nothing in the method of allocation under discussion which in any way collides with state laws forbidding dividends to be paid out of anticipated profits, or, what is the same thing, out of capital. If it be firmly grasped that Section 31 (b) is not directed to corporations or directors, does not prescribe or purport to prescribe how or when dividends shall be declared, does not authorize or purport to authorize any act or thing forbidden by state laws, but is merely a rule of law addressed to individual stockholders telling them the rate of tax which they shall pay on income received in the form of corporate dividends, much of the confusion pervading the briefs for the respondents will be dispelled. In no conceivable way can a statute commanding an individual who has received dividends from a corporation in the year 1917 to pay a tax at a certain rate on that part which is not in excess of his proportionate share of the earnings as determined at the end of the year, and a different rate on the excess, if any, collide with any state law forbidding the dissipation of

corporate capital through the payment of dividends.

VI

It is stated by respondents that the suggested method of allocation is inconsistent with the method adopted by the Treasury Department. It is true that the Department has not adopted the method of allocation by reference to the earnings as ascertained at the end of the year, but the precise method of allocation is not important here. The only question is, Should the distributions in question be allocated to 1917 earnings or Phelps Dodge Corporation and taxed to Dr. Douglas at 1917 rates, or does Section 31 (b) require that they be allocated to 1916 surplus and taxed at 1916 rates? On this question the long-continued and consistent construction of the section by the Department that dividends are to be allocated to current earnings is of great weight, in view of the large number of returns which have been settled on this basis and the large number of taxpayers who have received the benefit of it. On this fundamental question the departmental method of allocation and the suggested method agree. The possibility of this suggested method of allocation is an argument in favor of the construction of Section 31 (b) for which the petitioner contends. If the method of allocation adopted by the department should appear to the Court too complicated, the fact that a simpler method is possible under the statute is an addi-

tional reason for adopting the construction of Section 31 (b), which requires the allocation of dividends first to 1917 earnings and the taxation of the same at 1917 rates before resort may be had to the surplus of prior years with taxation at the much lower rates prevailing in those years.

WILLIAM D. MITCHELL,
Solicitor General.

ALFRED A. WHEAT,
RICHARD S. HOLMES,
Special Assistants to the Attorney General.

NOVEMBER, 1925.

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No. 524

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1924

William H. Edwards, Collector of Internal Revenue, Petitioner

Archibald Douglas, George Norman, and Edmund Coppin, as Executors of the Estate of James Douglas, Deceased, Respondents.

BRIEF OF RESPONDENTS IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

[illegible]

IN THE
SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1924.

WILLIAM H. EDWARDS, Collector of Internal Revenue, Petitioner

—against—

ARCHIBALD DOUGLAS, GEORGE NOTMAN, and EDMUND COFFIN, as Executors of the Estate of James Douglas, Deceased, Respondents.

No. 524

The petition and brief of the learned Solicitor General present considerations and arguments which would have been relevant and perhaps persuasive if addressed to the proper committees of Congress pending the passage of the 1917 Revenue Law. However, they have little bearing on the question of what the law as finally passed by Congress really means. The sole question in this case is whether, under Section 31 (b) of the 1917 Revenue Law, 1917 dividends should be deemed payable out of 1917 earnings, or out of an entirely different fund, called the "most recently accumulated undivided profits or surplus". The most striking thing

about the Government's argument is the fact that it absolutely fails to mention the main ground on which the Circuit Court of Appeals based its decision; namely, *the legislative history of the* 1917 *Law.* It does not even attempt to meet the argument that while the bill passed by the Senate clearly allocated 1917 dividends to 1917 earnings and taxed them at 1917 rates, the law finally passed by Congress omitted the Senate's language which clearly so allocated them, deliberately abandoned the Senate's plan, and allocated them to a fund which a few days earlier was recognized as an entirely different one; namely, the *"most recently accumulated undivided profits or surplus"*. This was the determining point in the case, and it is the sole point which the Government fails to discuss.

On behalf of the respondents, we submit the following:

I.

The record fails to disclose any grounds for granting the writ.

This court has repeatedly announced that the writ of certiorari should be "exercised sparingly and with great caution": that it is "solely questions of gravity and import" that justify its issuance. To quote its opinion in Lau Ow Bew, Petitioner (141 U. S. 583 at 587).

> "The inquiry upon this application, therefore, is whether the matter *is of sufficient*

importance in itself, and sufficiently open to controversy, to make it the duty of this court to issue the writ applied for" (Italics ours).

We contend that none of these grounds appear in the instant case.

It is not asserted:

(a) That there is any matter in this case affecting the interests of the Nation in its internal or external relations.

(b) That there is any conflict of law on the question sought to be reviewed between the Circuit Court of Appeals below, and any other Circuit.

(c) That there is any similar conflict of law between the decisions of the Federal Courts and that of a State Court in the Second Circuit or in any other Circuit.

(d) That the matter involved is of sufficient importance in itself, as distinguished from its importance to the litigants, to require this court to issue the writ.

(e) There is no question of fact or inference of fact presented—all the facts were stipulated.

But it is claimed by the government that the writ should be granted because there is a question of construction of the Internal Revenue Law of 1917 before the court, and this involves a large amount of refunds in this and other suits pending, and it is highly desirable that a uniform rule should be established by this court.

We discuss these contentions in Point IV below.

NOR IS THERE ANY AMBIGUITY IN THE ACT NECESSITATING JUDICIAL CONSTRUCTION

The sole question sought to be raised is (we quote from the petition, p. 3):

> "Under section 31 (b) of the Revenue Act of 1917 are distributions made by a corporation to its shareholders in the year 1917 taxable to the shareholders at the rates prescribed by law for the year 1917, if the corporation has earnings for that year sufficient to pay them, or must they be allocated to the surplus accumulated in prior years and bear the lower rates of taxation prescribed for prior years?"

We deny that there is any ambiguity in the section of the 1917 *Act requiring judicial construction. It is our contention that this act, in the phraseology used, in its gramatical structure and in the light of its legislative history, clearly allocates all dividends paid in* 1917 *to prior corporate surplus as distinguished from current earnings, and subjects such dividends to the lower tax rates then prevailing.*

The Act and its history, when examined, will so clearly establish the intention of Congress, that this court will be satisfied that no writ should issue.

II.

THE LEGISLATIVE HISTORY OF SECTION 31 (b) ESTABLISHES OUR POSITION.

Bearing in mind the established rule that in case of doubt taxing statutes are to be construed against the Government (Gould v. Gould, 245 U. S. 151; U. S. v. Merriam, 263 U. S. 179), and the equally well established rule that formal reports of committees having in charge pending legislation, as well as changes in the bill in the course of its passage, may be consulted in order to determine the meaning of a statute (U. S. v. St. Paul, etc. R. Co., 247 U. S. 310; Duplex Company v. Deering, 254 U. S. 443, 474), the present case presents no difficulty which requires a review by the Supreme Court.

The omission of all reference to the Legislative History, either in the petition or brief of the Solicitor General, requires a brief statement of it here.

Section 31 (b), originated in the Senate. Its legislative action may be graphically presented by paralelling the Section as *proposed* by the Senate and the same Section as finally passed by Congress, as follows:

Section 31 (*b*) *as proposed by the Senate.*	*Section* 31 (*b*) *as finally passed.*
"Any distribution made to the shareholders of a corporation in the year nineteen hundred and seventeen, or subsequent	"Any distribution made to the shareholders or members of a corporation, * * * in the year nineteen hundred

tax years, shall be deemed to have been made FROM THE NET INCOME OF THE YEARS IN WHICH SUCH DISTRIBUTION IS MADE OR IF SUCH INCOME IS INSUFFICIENT, from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the shareholder for the respective years in which *EARNED BY THE CORPORATION*, joint stock company or association, or insurance company, and shall be taxed to the shareholder at such rate prescribed by law for *(SUCH YEAR)*".

and seventeen, or subsequent tax years, shall be deemed to have been made from the most *recently accumulated undivided profits or surplus,* and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus *were accumulated by the corporation.*"

NOTE: Words in caps omitted in Law.

This shows a most significant change made in the proposed law by the Conference Committee and afterwards adopted. The Committee eliminated from Section 31 (b), the words "FROM THE NET INCOME OF THE YEARS IN WHICH SUCH DISTRIBUTION IS MADE, OR IF SUCH INCOME IS INSUFFICIENT". The Section as proposed by the Senate, without elision, was clear and unambiguous. If these words, subsequently omitted,

had remained in the Statute as passed, it would have expressed in most apt phraseology the very meaning which the Solicitor General now claims should be attributed to the Act. If such had been the case, any argument to the contrary by respondents would have been futile. The very words of the Section would, in unmistakable language, have allocated dividends declared in 1917 to the current earnings or net income of the year 1917 "if sufficient," but if not, then to the "most recently accumulated undivided profits or surplus" as it stood at the beginning of the year 1917.

This, it will be seen, is exactly the construction of the Act as passed for which our learned opponent contends. Unfortunately for his argument, Congress struck from the proposed act the very words which would have supported this contention. It elided from the Section all reference to the net income of the years in which such distribution is made. Congress thereby evinced beyond question its clear purpose to allocate dividends to another and different fund, to wit, "most recently accumulated undivided profits or surplus" of the prior fiscal period.

The Solicitor General attributes to this change in the proposed act no significance. He would have this Court construe the Section as passed, exactly as if no change had been made.

In the words of Chief Justice Taft:

> "Where an amendment changes the phraseology of a former Act, it will be presumed that it was the intention to make a corresponding change in its meaning." (U. S. v. Bashaw, 152 U. S. 436).

Congress certainly did not strike out these words in the belief that the phrase "net income of the years in which such distribution is made" was synonymous with the phrase "most recently accumulated undivided profits or surplus". The Act as proposed shows that the former phrase was used in contradistinction to the latter. It allocates distributions to the latter funds, only provided the *former "is insufficient"*. If synonymous, how could the former fund be insufficient, yet the latter suffice?

Nor can it be argued that Congress intended to make the statute ambiguous.

It therefore follows that Congress deliberately left out all reference to the current earnings or the "net income of the years in which such distribution is made", *in order that no distribution should be allocated to that fund.* The law-makers abandoned their original intention of attributing dividends declared in 1917 in the first instance to current earnings. In order to "encourage distributions" it was provided that they be attributed to undivided profits or surplus in the inverse order of its accumulation in prior years and bear the lower tax rates then prevailing.

The same abandonment of the original intention of the Senate appears from other changes made in the paragraph. While Section 31 (b) as proposed provided that 1917 dividends should constitute income of the shareholder for the year *"IN WHICH EARNED BY THE CORPORATION"* and should be taxed at the rate prescribed for *"SUCH YEAR"*, the law as passed provided that they should be taxed at the rates prescribed *"FOR THE YEARS IN WHICH SUCH PROFITS OR SURPLUS WERE*

ACCUMULATED". Again therefore appears the deliberate omission by Congress of all reference to *earnings.*

As Judge Mayer aptly says in delivering the opinion of the Circuit Court of Appeals:

> "While the Senate Finance Committee and Senate intended that the dividends declared in 1917 should be deemed to have been paid first from such net income as might be earned in 1917, it is plain that this program was not satisfactory to the Conference Committee. * * * *The real point of this legislative history is that the legislature was not, in this regard, dealing with current earnings, and by the most obvious procedure had eliminated current earnings from consideration as affecting the rate at which the taxpayer was to be taxed.*

And now the significance of the omission in the Solicitor's petition and argument of all reference to this legislative action becomes apparent. He is unable to meet the force of this argument growing out of this Congressional action. While the Bill as passed by the Senate clearly allocated 1917 distributions to current earnings and taxed them at 1917 rates, the law as finally passed deliberately abandoned this purpose and conclusively allocated them to the undivided profits or surplus of prior years.

Analyzed, this becomes:

III.

A CASE OF DEPARTMENTAL LEGISLATION

This case therefore resolves into an attempt of the Treasury Department to incorporate *by regulation* into the 1917 law a provision which Congress deliberately and specifically struck out. It is "Departmental legislation," which the court has frequently condemned.

In endeavoring to support this attempt, the Solicitor General, by a series of arguments, savoring of subtlety, strains to have the Court extend by implication, conjecture and inference, the plain words of a taxing statue so as to bring within the scope of the high surtaxes of the 1917 Act, distributions never so intended by Congress. Much of this argument is not addressed to the construction of the act itself, but is quite apart from its clear and obvious meaning. These arguments might have some place if adressed to a Congress Committee pending the passage of the Act. They have no application to its construction after its enactment.

Again, many of these arguments are predicated upon definitions of the words "profits" *simpliciter*. They ignore entirely the definite phrase of the act "most recently accumulated undivided profits or surplus".

This Court, in many of its opinions, has recognized that these phrases have a fixed significance and refer to a surplus definitely ascertained at the end of a fiscal period. Thus in Eisner v. Macomber, 252 U. S. 189 at p. 209, Mr. Justice Pitney said:

> "If profits have been made and are not divided they create additional bookkeeping, liabilities under the head of 'profit and loss', 'undivided profits', 'surplus account' or the like."

See also dissenting opinion of Mr. Justice Brandeis, in the same case.

> "It is a matter of common knowledge and indeed an obvious fact that accumulated undivided profits or surplus cannot be estimated without investigation or some appropriate method of accounting or calculation." (See Opinion, Court below).

That the above unmistakable conclusion is fair and reasonable further appears from certain well known facts, well expressed by the Court below (Italics ours):—

> "*A person or a corporation really does not know what are the profits of his or its business until the conclusion of some fixed period, whether it be a calendar or fiscal year.* If a corporation on February 1st of any year were to distribute in dividends profits made in the January immediately preceding, it might find that all these profits would, for one reason or another, be wiped out in March of the same year. If, one the other hand, the undivided profits or surplus accumulated in January were not distributed, it would be a misnomer to say that on February 1st of the same year there was on hand accumulated undivided profits or surplus for the month of January.

> In literal language, that might be true, because the undivided profits or surplus of January would have been accumulated in the sense that they had not been distributed. In taxing statutes, however, as in most other matters regulated by law, we do not deal in abstractions; and *an income tax statute usually provides for fixed periods as the measure of calculation and obligation, and this is because business, large and small, is done that way and no man in active business can tell where he stands financially for a given time, whether it be a calendar year or fiscal year or some other definite period, until he shall have arrived at the end of that period and is then able on facts known or ascertainable to determine, with reasonable approach to accuracy, what is his financial condition.*"

If Congress deliberately incorporates therein words having a recognized signification in business, they must be deemed to have used these words in that sense.

See *Southerland on Statutory Construction,* 2nd Edition page 777.

Thus we contend that the Act is clear, both in the accurate phrases used and when read in the light of the legislative history of the Section as envincing Congressional intention. It follows that there is no occasion for the interposition of judicial construction and no question sufficiently open to controversy requiring this court to issue the writ prayed for. This would seem to dispose of the application.

Certain other arguments, however, made by the Solicitor General require a brief comment.

IV.

OTHER ARGUMENTS OF PETITIONER DISCUSSED

The Solicitor argues that the writ should be granted because of the large amount of refunds involved in this and other suits pending, and alleges the payment of such refunds may seriously affect "the fiscal policy of the Government."

While respondents are at a disadvantage in the matter of criticising circumstantially the accuracy of the above general statement, we submit that on its face it appears exaggerated. It is difficult to believe that, over six years after the 1917 taxes were paid, any substantial refunds based on the decision in this case will "seriously affect the fiscal policy of the Government". Even if the amount involved be large, it will be relatively insignificant in comparison with the total taxes collected for the year in question.

The recovery of 1917 refunds can only be had by those taxpayers who have within the statutory period, now long since expired, preserved their rights by filing claims for refund and commencing suit. The number of such taxpayers and the amounts finally recoverable by them we feel sure are comparatively small. In its zeal for the granting of the writ, the Government has not substantiated its vague statements by actual figures from data within its possession. This omission is significant.

We in passing comment on the fallacy of the argument. The amount of tax collected by the Govern-

ment has no bearing on a construction of the act in question. If the construction is correct for the other reasons advanced, then the collections are legal. If illegal, then the amount thereof does not justify their retention.

As to the Government's contention that it is important that a uniform rule be prescribed on this point, it is sufficient to say that the refusal to grant the writ will promptly and effectually "prescribe the uniform rule" desired.

Further, the Solicitor argues in his brief that the act as construed by the Court below, would differentiate between corporations closing their books annually and those closing their books semi-annually or quarterly, and that, therefore, the rate of taxation might depend on the chance time of closing the books in particular cases. This argument mistakes plaintiff's contention. A corporation does not have a series of surplus during the year, merely because it closes its books quarterly or monthly. There is only one surplus for that year, arrived at by a balancing of the books *at the close of that year.* Income cannot be defined or arrived at *except over a period of time, and that by business custom and revenue laws is defined as a year.*

The entire structure of these Revenue Acts rests on a yearly period. It is imperative, therefore, with this system of taxation, that "the surplus and undivided profits" to which Section 31 (b) attributed distributions should be those determined on this yearly basis.

It is also suggested that the construction given by the Court below would lead to unjust and absurd results. The Solicitor's ingenious mind has devised

a number of such fanciful cases. These, however, are not attributable to the construction claimed by the plaintiff. As Judge Mayer in the court below well-said:

> "Experience demonstrates that however carefully framed, a tax statute rarely, if ever, can be drawn with such extraordinary foresight that it will provide for every possibility."

It is further urged that the construction of the Act by the Court below "leads necessarily to the conclusion that Congress intended to discriminate in favor of income derived from dividends and against income derived from interest, rent and personal effort".

But this alleged discrimination exists if either construction is adopted. Congress expressly exempted dividends from normal taxes, and gave a lower rate to dividends when paid out of surplus earned in years prior to 1917 "to encourage these companies to distribute their annual earnings." (See Conference Report, Congressional Record Page 8690). This avowed purpose would fail unless the Act created against other forms of taxable income the very discrimination which the learned Solicitor brands as "so unjust and so baseless".

V.

THE PETITION FOR WRIT OF CERTIORARI SHOULD BE DENIED.

Respectfully submitted,

MATTHEW C. FLEMING,
ARCHIBALD DOUGLAS,
PAUL ARMITAGE,
EDWARD HOLLOWAY,
Of Counsel.

September, 1924.

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1924

No. 524

WILLIAM H. EDWARDS, Collector of Internal Revenue
Petitioner

against

ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased

Respondents

On Writ of Certiorari to the Circuit Court of Appeals for the Second Circuit

BRIEF FOR RESPONDENTS

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1924.

WILLIAM H. EDWARDS, Collector of Internal Revenue,
Petitioner,

against

ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased,
Respondents.

No. 524.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF FOR RESPONDENTS.

Statement.

This is an action to recover additional income taxes paid on certain distributions received in 1917 by Dr. Douglas from Phelps Dodge Corporation, a company engaged in copper mining and smelting, and declared by the corporation to be from its "depletion reserve," the distribution in September, 1917, as we contend, being clearly non-taxable under the 1916 Law then in force.

At the outset let it be understood that the Court below did not grant to respondents an exemption from taxation;

but simply dividends taxed at lower rates than those claimed by the respondent.

The Court below held that as the company's accumulated surplus as of December 31, 1916, was amply sufficient to pay those dividends, they were presumed to be paid out of that surplus and were taxable at 1916 rates. The question before this Court is whether these dividends received in 1917, the first of which was non-taxable under the law in force at the time it was declared and paid, are taxable retroactively at the excessive surtax rates set up in the Revenue Act passed in October of that year, or whether the incidence of these 1917 rates was postponed three months to apply to distributions after January 1, 1918, with the assurance that the resulting lower taxes for 1917 would be made good in later years when tax rates began to drop year by year. In other words, shall the Court construe the words "most recently accumulated undivided profits or surplus" in Section 31 (b) of the 1917 Revenue Act in their normal and technical meaning, or by equitable construction extend them to include current earnings?

The Statute.

The portion of the Revenue Act of 1917 requiring construction is as follows, the first half of Section 31 (b) being particularly involved:

> "Sec. 31 (a). That the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint stock company, association, or insurance company, out of its *earnings or profits accrued since March first, nineteen hundred and thirteen,* and payable to its shareholders, whether in cash or in stock of

the corporation, joint stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of the *earnings or profits* so distributed."

"Sec. 31 (b). Any distribution made to the shareholders or members of a corporation, joint stock company, association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, *shall be deemed to have been made from the most recently accumulated undivided profits or surplus,* and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus *were accumulated* by the corporation, joint stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen." (Italics ours.)

The Facts.

Phelps Dodge Corporation, being a mining company, is permitted under the provisions of the various Revenue Acts to deduct from its annual earnings a reasonable allowance for depletion (exhaustion of its ore reserves) based on the value of its mines as of March 1, 1913. These provisions logically carry out the principle that when as-

sets owned on March 1, 1913, are sold, the taxable gain is the difference between the value on that date and the selling price. The values of the mines as of that date and the amounts, based thereon, to be deducted from annual income for each pound of copper produced, were determined by the Bureau of Internal Revenue in 1919 (Rec., pp. 40, 94), and related back to 1913. The amounts so deducted were annually set aside and added to a fund called "Depletion Reserve." Clearly in theory this depletion reserve should at the expiration of the life of any mine equal its value as of March 1, 1913, and this fund should at some time be distributed free of tax. Deducting dividends and depletion at Government rates from each year's earnings in each of the years 1913, 1914 and 1915 the company paid out in dividends more than its net profits, but at the end of 1915 had set aside from current earnings $14,197,847.31 in its depletion reserve (Rec., p. 32).

In the year 1916 "it had an excess of profits over dividends of $3,125,627.67" (p. 95), after deducting depletion *nunc pro tunc* for the years 1913, 1914 and 1915 at the rates fixed by the above Government appraisal (p. 24); or $7,982,248.57 after deducting depletion for those three years at the lower rates then in force and used by the company (pp. 32, 34). On March 1st, 1913 the surplus of the company was $108,275,606.69 made up of paid-in surplus, increase in value of property and earnings (pp. 24, 95). On December 31, 1916, the company's surplus, similarly made up, was $104,316,327.21 (p. 24). It added from current earnings to depletion reserve in 1916 $5,925,-161.34 (p. 92), making the total amount so set aside from current earnings since 1913 and carried in depletion reserve on December 31, 1916, $20,123,008.65. The amounts

so set aside from current earnings each year were as follows (Rec., p. 32):

1913	$4,747,251.87
1914	4,572,808.56
1915	4,877,786.88
1916	5,925,161.34
	$20,123,008.65

In 1917 Phelps Dodge Corporation, having this $20,123,008.65 in its depletion reserve, determined to make distributions therefrom to its stockholders from time to time, and not to wait until dissolution and final liquidation. It therefore in the year made two distributions, amounting to $8.00 a share, and plainly labeled them in its books and in its notices to stockholders as payments out of depletion reserve. Early in 1918 in their 1917 tax returns the stockholders stated that they had received these amounts, but were advised that they were distributions of capital and therefore not taxable. Later they were assessed additional taxes for 1917 on the theory that these dividends were income and not return of capital, and paid these taxes under protest. This suit was brought to recover such taxes.

Respondents' Contentions Below.

The contentions of the respondents in the Courts below were:

1. That Section 31 (b) does not apply to distributions *of capital* but simply creates a presumption as to the source of distributions *of income*.

2. That the word "deemed" in Section 31 (b) simply

gave rise to a rebuttable presumption, subject to be rebutted by showing the fund out of which the corporation actually paid the dividend.

3. That the distributions in question, being clearly intended and designated by Phelps Dodge to have been paid out of "depletion reserve," were returns of capital and not income within the meaning of either the statute or the Sixteenth Amendment.

4. That these distributions, if deemed to be income, were paid out of the company's most recently "accumulated surplus," viz., the surplus fixed at the end of the last accounting period, December 31, 1916; and were therefore taxable at 1916 or earlier rates.

Counsel for the Government argued in their brief in the Court of Appeals that any distribution which leaves on hand assets sufficient to cover the capital stock liability will be income, "even though the corporation distributes in specie what are commonly called capital assets."

Rulings of the Lower Courts.

The respondents were defeated on all these issues in the District Court (Opinion, Record, pp. 16-24). (287 Fed., 919).

The Circuit Court of Appeals affirmed the decision of the Court below on the first three points (298 Fed., 229). It sustained the position of the District Court that the distributions in question were income, because, in the language of the learned Solicitor General at page nine of his brief "a corporation having a surplus and making no reduction in its capital stock cannot make a distribution of capital."

The Court of Appeals held unanimously, however, that these distributions were conclusively presumed to have been paid out of December 31, 1916, surplus, and that, as there was on hand on that date "a sum amply sufficient to enable Phelps Co. to pay these dividends out of the accumulated surplus or undivided profits" (p. 109), they were taxable at 1916 rates (Opinion, Court of Appeals, Rec. pp. 93-99). Both courts held that the word "deemed" in Section 31 (b) creates a conclusive presumption.

So that the respondents were defeated below on the larger and more important branch of the case, under which, if they had been successful, mining companies, instead of waiting until the time of their final liquidation to distribute capital assets owned on March 1, 1913 (*Lynch* v. *Turrish*, 247 U. S., 221), might distribute such assets, tax free, from time to time during the life of the property. If they had won on this issue, it is their belief that they would have retained this right under the succeeding Revenue Acts.

The Question Involved.

Section 31 (b) of the 1917 Revenue Act (p. 2, *supra*) provides that dividends shall be deemed to have been paid "*from the most recently accumulated undivided profits or surplus,*" and shall be taxed "at the rates prescribed by law for the years in which such profits or surplus were *accumulated by the corporation.*" The question is whether these words are used on their well known correct and technical meaning as referring to earnings which have been determined to constitute "undivided profits or surplus" by the taking of inventories and the balancing of books, and have been "accumulated" by the expiration of a definite accounting period and their final addition to

surplus account upon the corporation's books; or whether this usual technical meaning shall be enlarged by equitable construction so as to include "current earnings," earnings *apparently existing* at the time of the dividend, but existing only in the absence of inventory and subject to losses during the remainder of the corporate year, earnings which have not been "accumulated" or become either "undivided profits or surplus." In other words, the question is whether the rule laid down by Congress was that in determining the rate at which dividends paid in 1917 and subsequent years should be taxed, it was to be deemed that the dividend was paid out of "undivided profits or surplus" accumulated during the most recent preceding calendar or fiscal year, or was paid out of current earnings for the period between January 1 and the date of payment of the dividend—earnings the amount or existence of which would not only be unknown at the time of the declaration and payment of the dividend, but in most cases forever unascertainable except by arbitrarily prorating the subsequently determined profits of the entire accounting period of the corporation.

Neither party seeks to review the interpretation of the word "deemed" as creating a conclusive presumption, although if it simply creates a rebuttable presumption, the judgment of the Court below should be affirmed, as the presumption is clearly rebutted by the acts and declarations of the company paying the dividends (Pet. Brief, pp. 5-6).

The Government contends that the phrase "most recently accumulated undivided profits or surplus" in Section 31 (b) includes "current earnings," or "net income" of the year when dividends are paid; and that therefore 1917 dividends are *conclusively presumed* to have been

paid out of 1917 earnings until those earnings are first exhausted. The Government further contends that it may arbitrarily prorate the year's total earnings, not ascertained till the end of the year, down to the date of any particular dividend.

The respondents contend that the phrase "most recently accumulated undivided profits or surplus" does not include current earnings, but means the surplus accumulated and fixed at the end of the last accounting or fiscal period; and that therefore the dividends in question are conclusively presumed to be paid out of that surplus and not out of current earnings. In support of this contention, they submit the following:

I. The changes made in Section 31 (b) while pending in Congress, show conclusively that the "most recently accumulated undivided profits or surplus" could not possibly have been intended to include net income of the current year, or current earnings.

II. The words "accumulated undivided profits or surplus" have an exact and well-settled meaning in business, in accounting and in law. They designate the surplus accumulated or amassed at the end of the last fiscal period and exclude current earnings.

III. The arguments of the learned Solicitor General are unsound.

IV. The construction adopted in the Court below is just to the Government and to the taxpayer.

ARGUMENT.

I.

The changes made in Section 31 (b) while pending in Congress show conclusively that the "most recently accumulated undivided profits or surplus" could not possibly have been intended to include net income of the current year, or current earnings.

It is clear, as we shall attempt to show under Point II, that technically the phrase "most recently accumulated undivided profits or surplus" refers to earnings which have been determined to constitute "undivided profits or surplus" by the taking of inventories, the balancing of books and other adjustments, and have been accumulated by the expiration of an accounting period and an addition to surplus upon the books of the corporation. This is the fund from which dividends are normally declared and paid. Shall this Court read these words in their *correct* and *technical meaning,* or shall it exercise its power of equitable interpretation to read them as including current earnings? We say that if any one thing is made clear by the legislative history of Section 31 (b), it is that Congress did not intend to include current earnings in the "most recently accumulated undivided profits or surplus." The question, as Hawkins says in his "Principles of Legal Interpretation," is "not what the writer meant, but what he has authorized the interpreter to say it is probable was his meaning."

Bearing in mind the established rule that in case of doubt taxing statutes are to be construed against the Government (*Gould* v. *Gould,* 245 U. S., 151; *U. S.* v. *Merriam,*

263 U. S., 179), and the equally well established rule that formal reports of committees having in charge pending legislation, as well as changes in a bill in the course of its passage, may be consulted in order to determine the meaning of a statute (*U. S.* v. *St. Paul, etc., R. Co.*, 247 U. S., 310, 318; *Duplex Company* v. *Deering*, 254 U. S., 443, 474), the present case presents no difficulty.

The Government argues that the above principles do not apply, because the taxpayer in this case is seeking an exemption from taxation. It is not necessary to answer this argument in detail, for it is sufficiently taken care of by the opinion of the Court below, as follows (Record, page 101):

> "The cases, like Bank of Commerce *v.* Tennessee, 161 U. S., 134, 146, and Cornell *v.* Coyne, 192 U. S., 418, 431, in which the doubt is resolved in favor of the Government and against the taxpayer are those in which the taxpayer claims *an exemption* or a privilege.
>
> "That is not this case. Here, so far as concerns, in this regard, the construction of Section 31 (b), plaintiffs do not ask for an exemption or privilege; on the contrary, they assert that, as matter of right under the statute, the deceased shareholder should have been taxed at other than the 1917 rate."

In Section 31 (b) Congress changed the rule that dividends were taxable at the rates of the year in which they were *received by the stockholder*, and made them taxable at the rates of the year in which the fund from which they were paid *was accumulated*. In doing this Congress must have contemplated that the result would be that certain dividends received during 1917 would be taxed at the lower rates applicable to past years—if, indeed, that was not the very purpose which prompted the change.

Congress must, however, also have contemplated that it was not granting an exemption, but was merely postponing as to certain dividends the impact of taxation at war rates. Rates were then increasing; but when the tide should turn, as it was hoped it would, and rates should be decreasing year by year, dividends then received would be taxable at the higher rates applicable to some past year.

The correct rule is well expressed by Mr. Justice Sutherland in *U. S.* v. *Merriam,* 263 U. S., 179, in which he quotes with approval the rule as stated by Lord Cairns in *Partington* v. *Attorney General* (L. R. 4 H. L., 100, 122) as follows:

> "On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the spirit of the law the case might otherwise appear to be. In other words, if there be admissible in any statute what is called an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute."

(a) History of the 1917 Revenue Act.

With these principles in mind, let us examine the history of the 1917 Revenue Act, and the changes made by the 1918 and 1921 Acts.

(1) *The definition of "dividends" in the 1916 Revenue Act.*

We wish to emphasize the fact that under the Revenue Act of 1913 all dividends were taxed at the rates applicable to the year in which they *were received* by the stockholders. So that in order to appreciate clearly the

purpose of Section 31 (b) of the 1917 law and the circumstances attending its passage, it is necessary to go back to refer to this principle, finally settled by *Lynch* v. *Hornby*, 247 U. S., 339, which held that "ordinary" dividends received after March 1, 1913, even though derived from a surplus existing on March 1, 1913, were taxable as income and at the rates of the year *when received.*

That case, in which the Government took the position later sustained by the Supreme Court, was begun in 1915. While the taxpayer won in the lower courts, the question was still open in 1916, and therefore, as the Supreme Court says (p. 346), "as a concession to the equity of stockholders" Congress in the 1916 Revenue Act inserted a definition of "dividends" in practically the same language as in Section 31 (a) quoted above (p. 2), viz., as payments by a corporation out of "earnings or profits accrued since March 1, 1913." Therefore, after the passage of this bill on September 8, 1916, and well into the fall of the year 1917, many corporations made large distributions to their shareholders, labeling such distributions to be from surplus accumulated on March 1, 1913. They contended that these dividends were non-taxable under the above definition, and the Government acquiesced in this contention.

(2) *Senate Finance Committee's report of July 3, 1917.*

It was soon felt that the 1916 Law, in its efforts to ameliorate the harshness of the rule then asserted by the Government and announced later in *Lynch* v. *Hornby*, Congress had gone too far in the other direction. Therefore when Congress began the consideration of the 1917 Law it determined to correct this defect. However, when the bill passed the House in May, 1917, it simply repeated the above definition of dividends, and made no attempt what-

ever to correct the defect in the 1916 Act above mentioned. In this form the new bill went to the Senate and was referred to its Finance Committee on May 25. On July 3 it was reported by the Finance Committee with amendments which repeated the above definition of dividends, but added thereto the following as a part of Section 10 (a) (italics ours):

> "Provided further, That dividends declared and paid in the year 1917, *or subsequent tax years*, shall be deemed to have been paid *from the net income of the year in which paid*, or *from the most recently accumulated surplus*, and shall constitute a part of the annual income of the shareholder for the respective years in which *earned* by the corporation, joint stock company, association or insurance company, and shall be taxed to the shareholder at the rate prescribed by law for such years."

Here early in July was the first suggestion that dividends should constitute income of the shareholder for the respective year in which earned by the Corporation (but not for the year when received) together with a plain recommendation that dividends paid in 1917 and subsequent years should be deemed to be paid from the "*net income of the year when paid*," or from the "*most recently accumulated surplus.*" Two things were then absolutely clear:

(1) That "most recently accumulated surplus" was a surplus accumulated in prior years, and was regarded and intended to be something entirely distinct from "net income" of the year in which the dividend was paid, or current earnings; (2) that corporate earnings, to the extent that they were distributed, were to be treated as the income of the stockholders for the year "in which earned by the corporation" and taxed at the rates of such years.

(3) *Senate Finance Committee's report of August 6, 1917.*

The bill was recommitted and on August 6 was again reported by Senator Simmons for the Finance Committee. The proposed new bill repeated the definition of "dividends" above set forth (now Section 31 [a]) and added the following (italics ours):

> "Provided further, That any distribution made to the shareholders of a corporation, joint stock company, or association, or insurance company, in the year nineteen hundred and seventeen, *or subsequent tax years,* shall be deemed to have been made from the *net income of the year in which such distribution is made or, if such income is insufficient, from the most recently accumulated undivided profits or surplus,* and shall constitute a part of the annual income of the shareholder for the respective *years in which earned* by the corporation * * * and shall be taxed to the shareholder at the rate prescribed by law *for such years*" (Cong. Rec., Vol. 55, Part 7, pp. 6869, 6870, 6877, 6886).

Here again dividends are made income for the year when earned, and it is still more clear that whatever the phrase *"most recently accumulated undivided profits or surplus"* meant, it certainly did not include *"current earnings."* It certainly did not mean *"net income of the years in which such distribution is made,"* but the most recent surplus accumulated in prior years; for it was only when this net income was exhausted, that dividends were deemed to be paid out of the "most recently accumulated undivided profits or surplus."

(4) *Senate Bill passed September 10, 1917.*

On September 10 the bill was passed by the Senate in exactly the above language recommended by the Finance Committee on August 6. It will be instructive and valuable to examine in some detail this Section 31 (b) as passed by the Senate [then a part of Section 2 (a)]. It was to this Senate bill of September 10, and not to the Conference Committee bill, that Senator Simmons was referring on October 2 in the oral debate, quoted in part in Judge Mayer's opinion at page 106 of the Record, as follows:

> "In this condition of the law it was clearly to the interest of the corporation to distribute its surplus accumulated before 1913 instead of that more recently accumulated.
>
> "In order to be just to the corporations and at the same time to encourage them to distribute *their annual earnings, your committee reported to the Senate and the Senate adopted* an amendment providing that the surplus when distributed shall be taxed to the distributee at the rate prescribed by law for the year in which *they were earned,* but also provided that any distributions of surplus made in 1917 or subsequent tax years should be deemed to have been made from the most recently *accumulated undivided profits, thereby making it necessary* for the corporation to distribute its *surplus* earned since March 1, 1913, before that earned prior to that time." (Cong. Rec., page 8690.)

Whatever Senator Simmons' somewhat confused language meant, it is a fairly accurate synopsis of the Senate bill of September 10. It must have referred to that bill, for it is described as a bill which *"your committee reported"* and the *"Senate adopted,"* which language fits nothing else. Note also that he says that the bill made

it necessary to distribute "surplus earned since March 1, 1913," and not "earnings accrued" since that date.

We submit that this Senate bill clearly intended to allocate dividends of 1917 and subsequent years: (1) to current earnings; (2) after current earnings were exhausted, to the most recently accumulated undivided profits and surplus; and (3) after exhausting all surplus accumulated since March 1, 1913, then to the March 1, 1913, surplus. These provisions, as Senator Simmons states, made it necessary for the corporation to distribute its "surplus earned since March 1, 1913, before that earned prior to that time."

He does not say that it was necessary to distribute "earnings or profits accrued" since March 1, 1913. As the Court belows says (pp. 106, 107):

> "There is no suggestion in this report that 'most recently accumulated surplus or undivided profits' was intended to refer to 1917. On the contrary, the observation as to encouraging corporations to distribute 'their annual earnings' indicated a clear understanding that accumulated 'undivided profits or surplus' are ascertained upon some annual basis; and the Committee was distinguishing between surplus accumulated before March 1, 1913, and surplus accumulated after that date."

The suggestion that the words "net income" were eliminated because they were not apt or fitting falls to the ground when one notes in the Act of 1917 itself, in the regulations based thereon, and in the 1918 Act, the indiscriminate way in which Congress and the Bureau of Internal Revenue use the words "net income" and "earnings or profits." Regulations 45 are full of such instances. For instance, compare Section 201 (e) of the 1918 law, which uses the words "earnings or profits," with Article 858

of Regulations 45, construing this very section, in which Article the Bureau of Internal Revenue uses, instead, the words "net income." As for the 1917 Act, a good example is Section 10 (b), which provides for an additional tax of 10% upon the amount remaining undistributed six months after the end of a corporation's year "of the *total net income* of every corporation * * * received during the year," compared with Section 3 of the same law, providing an additional tax to shareholders on the undistributed "gains or profits" of the corporation; for all through this section the words "gains or profits" are used instead of "net income." Section 3, it should be noted, speaks of gains or profits which are permitted to *accumulate and become surplus.*

Besides as the Court below says,

> "before the *net income* of a year can be determined, the *net earnings* must first be ascertained."

(5) *Conference Committee's bill passed by Congress October 2, 1917.*

After the passage of this bill by the Senate on September 10, it went to conference about September 15, was reported out by the Conference Committee on September 29 and on October 2 was passed by both houses of Congress in exactly the language of the Conference Committee and of Section 31 (b) (pp. 2, 3, *supra*). Bear in mind that the bill as it passed the Senate made a clear distinction between *current earnings* and *"most recently accumulated undivided profits or surplus,"* and clearly and unmistakably allocated 1917 dividends to 1917 earnings and taxed them at 1917 rates. The adoption of this rule by the Senate was entirely logical, because the theory of the Senate bill was that corporate earnings, to the extent that they were distributed, were to be treated as the income of the

stockholder *"for the year in which earned by the corporation"* and should be taxed at the rate prescribed by law *for such years.* It would have been entirely inconsistent with that theory to ignore current earnings in the taxation of dividends. But the Conference Committee rejected the theory of the Senate bill that dividends should constitute a part of the income of the stockholder for the year in which earned by the corporation. It reverted to the former theory, that dividends should be income of a stockholder for the year in which received, but introduced the principle that they should be *taxed at the rates* applicable to the year in which the "profits or surplus" from which they were paid "were accumulated by the corporation." Having done that, it would have been entirely illogical to retain the Senate rule that dividends were to be deemed to have been paid from current earnings, because, as everyone knows, this is not the fund from which dividends are paid. Therefore, the Conference Committee and Congress struck out the provision that dividends should be deemed to have been paid from *current earnings,* and retained the provision that they were to be deemed to have been paid *"from the most recently accumulated undivided profits or surplus."* It would seem that in so doing Congress was acting deliberately and advisedly, that it rejected the rule that dividends should be deemed to have been paid from current earnings, and substituted the logical and appropriate rule that they were to be deemed to have been paid out of accumulated surplus.

As the Court below summed the matter up (Record, p. 107):

> "While the Senate Finance Committee and Senate intended that the dividends declared in 1917 should be deemed to have been paid first from *such net*

> *income as might be earned in 1917*, it is plain that this program was not satisfactory to the Conference Committee. * * * *The real point of this legislative history is that the legislature was not, in this regard, dealing with current earnings, and by the most obvious procedure had eliminated current earnings from consideration as affecting the rate at which the taxpayer was to be taxed.*" (Italics ours.)

In other words, the Conference Committee deliberately and advisedly, and for reasons which it deemed sufficient, determined to lay down the principle that the rates at which dividends should be taxed against the stockholder would depend not upon *when he received the dividends*, but *upon when the fund out of which they were paid was accumulated* by the corporation, thereby preventing the taxation at war rates of earnings which were not war earnings. In doing this, *it rejected the theory of the Senate bill* that the earnings of a corporation were to be treated *as the income of the stockholder* for the year in which they *were earned* by the corporation, which was a perfectly fantastic theory, and would, in the language of the Government, "have produced endless confusion" (Petitioner's Brief, p. 30). It deliberately adopted the practical theory which recognized that the fund out of which dividends are paid is accumulated surplus and not current earnings. This being the theory on which the Conference Committee proceeded, it was necessary to prevent its abuse through the express declaration of dividends first out of surplus accumulated in years of low taxation. It did this by creating the presumption that dividends were paid out of the "most recently accumulated surplus." There is absolutely no reason for saying that in using those words it intended to include current earnings. They are not included in the normal and usual definitions. The adoption of this theory of taxation in-

volved no favoritism or exemption. At most, it postponed the time at which the high rates of taxation should be paid by stockholders. It was a perfectly logical and sensible theory, whether regarded from the point of view of fairness to the taxpayer or advantage to the Government in encouraging distributions during 1917.

Counsel for the Government argues that Congress never intended to distinguish between "current earnings" and "accumulated profits" or surplus; that all that it did by the elision was to omit any reference to "net income" because this term was not synonymous with "current earnings"; that it was of more limited import, and if used, would have excluded a large amount of current earnings that were not technically "net income," for example, corporate income from tax exempt securities or dividends of other corporations. Therefore, it is argued, Congress struck out these words (Plff's Brief, pp. 27-33).

But why, it may be asked, if Congress in the draft employed a phrase too narrow in significance to express its intent, did it not substitute the appropriate one, *i. e.*, "current earnings." The allocation would then be to "the current earnings of the year in which such distribution is made, or, if such earnings are insufficient, to the most recently accumulated undivided profits or surplus," etc. Certainly the Government will admit that this would have exactly expressed the construction claimed by it beyond all doubt.

Why, because a term inaptly conveyed its meaning, should Congress strike out all reference to the subject or class—leaving it to implication or inference? Why, in framing a tax Act, leave open to conjecture and dispute ambiguous phraseology, when so simple and natural a substitution of the appropriate words "current earnings" would have made the intention clear?

In view of the above deliberate change of principle in the two bills, no further reply is necessary to the Government's arguments that the above changes in phraseology are an "improvement in draftsmanship," or an "expression of the same intention in more appropriate language" (Brief, p. 29); that by the omission of the words "net income" Congress "did not change its intention, but "merely expressed that intention more appropriately" (p. 30); or that these changes were "designed not to change the meaning expressed in the Senate bill, but to express that intention in clearer and more precise language" (Brief, p. 32).

(6) *The Proviso added by the Conference Committee.*

The Conference Committee reported and Congress passed an addition to the above part of Section 31 (b) in the nature of a proviso, as follows:

> "but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen" (Cong. Rec., Vol. 55, Part 8, pp. 7613, 7614).

As is said elsewhere, if the Government is right in its contention that the "most recently accumulated undivided profits or surplus" in the first half of 31 (b) includes current earnings, if the bill as passed simply expressed the

intention of the Senate bill "in clearer and more precise language," then this proviso is surplusage, excepting perhaps in the one respect noted below. For the necessary result of charging dividends first to current earnings and then to prior accumulated surplus, would be to compel the distribution of current earnings of the taxable year down to the dividend date and all prior surplus accumulated in taxable years, before earnings profits accrued prior to March 1, 1913, could be distributed tax free—which is just what the proviso says. Why, then, the proviso? Under the respondent's interpretation of the law, two explanations are possible: 1.—Congress, instead of taxing dividends, as did the Senate Bill, at the rates of the years when the corporation earned the income, taxed them at the rates of the years when the surplus was accumulated. So that there was only one fund, determined at the end of each year, which was the accumulated surplus of that year. It was possible, therefore, that certain 1917 dividends, after exhausting the intermediate surpluses, might be allocated to the December, 1913, surplus. This surplus might include earnings of January and February, 1913, which, under Subdivision "a," should have been tax-free. To avoid this conflict between Subdivisions "a" and "b," the proviso may have been inserted. It is to be noted that under the government's theory, which makes no distinction between "undivided profits and surplus" and "current earnings," this conflict would not arise. 2—Congress may have appreciated that it was changing the rule of the Senate Bill in excluding current earnings for the purposes of determining the rate at which dividends should be taxed, but did not wish to exclude current earnings for the purposes of granting an exemption from taxation. Surely on either theory the proviso cannot enlarge the meaning of the phrase which it limits, and so extend the fund against which all the distributions are to be charged ("the most recently accumulated undivided profits or surplus"), so as to include current earnings:

A comparison of the Senate bill and the corresponding portion of the act as reported by the Conference Committee and passed by Congress furnishes a demonstration of the foregoing argument:

Senate Bill, passed by the Senate September 10.	*Conference Bill, passed by Congress October 2.*
Any distribution made to the shareholders of a corporation, joint stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent years, shall be deemed to have been made	Any distribution made to the shareholders (or members) of a corporation, joint stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent years, shall be deemed to have been made
from the net income of the *years in which such distribution is made, or, if such income is insufficient,*	
from the most recently accumulated undivided profits or surplus,	*from the most recently accumulated undivided profits or surplus,*
and shall constitute a part of the annual income of the shareholder for the respective years in which *earned* by the corporation, joint stock company, or association, or insurance company, and shall be taxed at the rate prescribed by law *for such years.*	and shall constitute a part of the annual income of the distributee for the year in which *received,* and shall be taxed at the rates prescribed by law for the years in which such *profits or surplus were accumulated* by the corporation, joint stock company, or association, or insurance company, but nothing herein, etc. (See Proviso quoted immediately above).

So much for the history of the 1917 Revenue Act.

(b) The significant changes made by the 1918 and 1921 Revenue Acts.

It is interesting to note that Section 201 (b) of the Revenue Act of 1918 provided that:

> "Any distribution shall be deemed to have been made from *earnings* or *profits* unless all earnings and profits have first been distributed."

And that Section 201 (b) of the Revenue Act of 1921 provided:

> "For the purpose of this act every distribution is made out of *earnings* or *profits*, and from the most recently accumulated earnings or profits, to the extent of such *earnings or profits accumulated* since February 28, 1913."

We submit that the use of these words "earnings or profits" in the sections of the 1918 and 1921 statutes corresponding to Section 31 (b) of 1917 Act, to refer to current earnings of the taxable year, does not clarify the intent of Section 31 (b) in favor of the interpretation placed upon the section by the Government. If anything, the latter acts make it clear that in the former act the intention of Congress was as urged by the respondents, and that Congress later changed its mind.

Again, Section 201 (e) of the Revenue Act of 1918, now held to apply to invested capital and not to surtax rates on dividends, after providing that a distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years, goes on to say:

> "But any distribution made during the remainder

> of the taxable year shall be deemed to have been made from *earnings or profits accumulated between the close of the taxable year and the date of distribution*, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the *earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period.*"

The words used by Congress in the Act of 1918 clearly laid down precisely the rule which in the case at bar the Government contends Congress laid down with respect to dividends in the 1917 Act. We are not concerned with the reason why Congress laid down this rule in 1918. All that is material for present purposes is that when Congress did intend to lay down that rule, it used appropriate but quite different language, and carefully explained the complicated and artificial computation which it involved.

> See *Shwab* v. *Doyle*, 258 U. S., 529;
> *Smietanka* v. *First Trust & Savings Bank*, 257 U. S., 602.

In the Shwab case the Court said (italics ours):

> "If Congress, however, had the purpose assigned by the Commissioner, it should have declared it; *when it had that purpose it did declare it.* In the Revenue Act of 1918 it re-enacted Section 202 of the Act of September 8, 1916, and provided that the transfer or trust should be taxed whether made or created before or after the passage of the Act. And we cannot accept the explanation that this was an elucidation of the Act of 1916, and not an addition to it, as averred by defendant, but regard the Act of 1918 rather as a declaration of a new purpose; not the explanation of an old one."

In this connection it is interesting to note that the District Judge in *Harder* v. *Irwin*, 285 Fed., 402, cited by the Government (p. 59), speaks of the 1918 amendment as "*removing the ambiguity* arising from the words 'most recently accumulated undivided profits or surplus'" in the 1917 Law. In view of the learned Judge's charges made in the definite Senate bill of September 10, by the Conference Committee, far from expressing "the same intention in more appropriate language" (Pet. Brief, pp. 29, 32), left the act "ambiguous."

See also *Sutherland on "Statutory Construction"* (Second Ed., p. 777).

II.

The words "accumulated undivided profits or surplus" have an exact and well-settled meaning in business, in accounting and in law. They designate the surplus accumulated or amassed at the end of the last fiscal period and exclude current earnings.

The well known practices and necessities of business are the best guide, remembering always that the Government must prove that the fund called "most recently accumulated undivided profits or surplus" is in ordinary business experience commonly known and regarded as including "current earnings"; and that even if the Government should succeed in proving this point, there is still the stumbling block of the above legislative history to surmount. Surely, if, as we contend, the meaning of this phrase as fixed by the above legislative history is in exact accord with that of business experience, then the argument is unanswerable.

Illustrations may be drawn from:

(a) Business Usage.

As the Court below says (p. 104):

> "It is a matter of common knowledge and, indeed, an obvious fact that the accumulated undivided profits or surplus cannot be ascertained without investigation or some appropriate method of accounting or calculation. The ordinary methods of corporate accounting in this regard have been recognized by the Supreme Court."

See also the opinion of Mr. Justice Pitney in *Eisner* v. *Macomber*, 252 U. S., 189. Justice Pitney says:

> "When only a part (of the year's profits) is available for dividends, the balance of the year's profits is carried to the credit of UNDIVIDED PROFITS OR SURPLUS OR SOME OTHER ACCOUNT HAVING LIKE SIGNIFICANCE. If thereafter the company finds itself in funds beyond the current needs it may declare dividends out of SUCH SURPLUS OR UNDIVIDED PROFITS ACCOUNT."

Here Justice Pitney uses the words "undivided profits" and "surplus" as of *"like significance,"* and referring to the surplus account at the close of the fiscal year. This is the exact and correct use of the terms.

Again, in the same case, the learned Justice says:

> "For bookkeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a 'capital stock account.' If profits have been made and not divided they create additional bookkeeping liabilities under the head of *'profit and loss,' 'undivided profits,' 'surplus account,'* or the like."

It is well recognized that in business enterprises, particularly large ones, "surplus or profits" cannot arise until there is a balancing of the books, a taking of stock and an adjustment of income and outgo for the fiscal period of the business. It is only after this closing of the books that the undivided profits or surplus for a period are accurately ascertained. As stated by Mr. Justice Brandeis in his dissenting opinion in *Eisner* v. *Macomber*, 252 U. S., at page 230 (italics ours):

> "Business men, dealing with the problem practically, *fix necessarily periods and rules for determining whether there have been net profits—that is, income or gains.* They protect themselves from being seriously misled by adopting a system of depreciation charges and reserves. Then, they act upon their own determination, whether profits have been made. Congress in legislating has wisely adopted their practices as its own rules of action."

And, again, at page 232:

> "Many corporations, without legally capitalizing any part of their profits, had assigned definitely some part or all of the annual balances remaining after paying the usual cash dividends, to the uses to which permanent capital is ordinarily applied. Some of the corporations doing this, transferred such balances on their books to 'Surplus' account,—distinguishing between such permanent 'Surplus' and the 'Undivided Profits' account. Other corporations, without this formality, had assumed that the annual accumulating balances carried as undistributed profits were to be treated as capital permanently invested in the business. And still others, without definite assumption of any kind, had so used undivided profits for capital purposes."

The opinion of the Court below so admirably expresses the difficulties to which any other construction of Section 31 (b) would lead that it will be sufficient for our purposes to quote from this opinion here (Record, pp. 104, 105):

> "A corporation does not ordinarily set up on its books in the intermediate course of a year the amount of its accumulated surplus or undivided profits. *It is manifestly impracticable from month*

to month to take inventories or compile data to ascertain what surplus or undivided profits have been accumulated for a fraction of a current year. Accumulated surplus or undivided profits are ordinarily ascertained at the end of a given calendar or fiscal year. What are the true accumulated undivided profits or what is the true accumulated surplus is always a question of fact and, under a revenue statute, that question of fact is usually determined by the appropriate bureaus of the Treasury Department subject to such review as may be provided by statute. *A person or a corporation really does not know what are the profits of his or its business until the conclusion of some fixed period, whether it be a calendar or fiscal year.* If a corporation on February 1st of any year were to distribute in dividends profits made in the January immediately preceding, it might find that all these profits would, for one reason or another, be wiped out in March of the same year. If, on the other hand, the 'undivided profits or surplus' accumulated in January were not distributed, it would be a misnomer to say that on February 1st of the same year there was on hand accumulated undivided profits or surplus for the month of January. In literal language, that might be true, because the undivided profits or surplus of January would have been accumulated in the sense that they had not been distributed. In taxing statutes, however, as in most other matters regulated by law, we do not deal in abstractions; and *an income tax statute usually provides for fixed periods as the measure of calculation and obligation, and this is because business, large and small, is done that way and no man in active business can tell where he stands financially for a given time, whether it be a calendar year or fiscal year or some other definite period until he shall have arrived at the end of that*

period and is then able on facts known or ascertainable to determine, with reasonable approach to accuracy, what is his financial condition." (Italics ours.)

The corporation whose dividends are in question in the case at bar is a good example. The nature of the business of Phelps-Dodge Corporation requires that, in determining its income, inventories be taken at the close of the yearly accounting period, which necessarily postpones the determination of the profits till after that date. The regulations of the Treasury Department so require.

Again, this company has recognized the principle embodied in Section 31 (b) by charging its dividends of the current year against the surplus account of the preceding year. (See Plaintiff's Exhibits N and O; Record, pp. 48-50). For example, Exhibit O shows the "general profit and loss" surplus for the year 1917 as $14,588,711, which surplus is carried, unimpaired by the year 1917 dividends, to the "general surplus" account as of December 31, 1917, in Exhibit N. Phelps-Dodge also furnishes a very good example of just what often happens to companies which usually hope to receive a fairly large and uniform income. For in the year 1913, and again in 1923, the company suffered losses running up into very large sums of money from explosions in one of its coal mines at Dawson, New Mexico, where several hundred lives were lost. Each of these explosions wiped out the profits of that coal property for years. And again in the year 1921, the Government's requirement that copper be inventoried either at cost or market, whichever is the lower, resulted in a loss of over six million dollars, exclusive of depletion, due to the fact

that the selling price of copper at the end of the year had dropped below cost.

It may be suggested that the same difficulties and inequalities will attend an annual accounting. This is true to such an extent that certain economists suggest as an ideal, to accompany their "economic income," longer fiscal or accounting periods. The real answer is the one given by the opinion of the Circuit Court of Appeals (page 31 *supra*), that business is done on an annual basis, and particularly that in the various revenue acts Congress has provided for an annual accounting and balancing of the books.

In many businesses, notably banking institutions, the general "surplus" account is subdivided into two accounts (1) "undivided profits" and the other "surplus" account. In such systems the "surplus" account denotes the *permanent surplus* invested in the business and not available for dividend distribution. It represents the profits accumulated over prior years that have been permanently invested in the business of the corporation. The "undivided profits" account, on the contrary, represents that portion of the accumulated profits of previous years, that have not been distributed as dividends but is still available for that purpose. So it is a subdivision of the surplus account—the former being a permanent surplus and the latter being liquid surplus available for future dividends. So held by Supreme Court in *Fidelity Title & Trust Co.* v. *U. S.*, 259 U. S., 304. See also *Bank* v. *Treat.* 116 Fed., 774, 128 Fed., 262, and cases cited.

As stated by the Internal Revenue Department, "the *present Federal income tax system is based upon an annual accounting period*" and "the object of an inventory is to assign to an annual accounting period its profits and

losses." T. B. R., 65, Cumulative Bulletin of the Internal Revenue Department of December, 1919, pp. 51-52.) From the outset the Commissioner of Internal Revenue has recognized that in certain classes of business, inventories at the beginning and close of the year were essential. (See Regulations 33, issued January 5, 1914, Article 161, Paragraphs 353-4, 396, 481; also Article 91.) The rule announced is that such inventories must be taken "at cost or market, whichever is lower." (T. D., 2744.) It is expressly provided that in such cases no other method of arriving at the cost of the goods sold "will be approved." (Regulations 45, Articles 1581-85, T. B. R., 48, Cumulative Bulletin, 1919, p. 47, p. 62.)

Hence corporations which are required to take inventories at the "first and last day" of the taxable year, cannot know the cost of the goods and hence, the net profits, until the end of the year. Whether the market value or the cost of the goods is lower cannot be ascertained until the market quotations at the *end of the year* are known. Hence the determination of the cost of the goods is postponed until the end of the year. In a rapidly falling market businesses find at the end of the year serious losses in inventory which destroy apparent large current earnings of the earlier months

(b) Accounting Principles and Practice.

There is no dispute as to the principle that technical words used in a statute in reference to a subject as to which they have acquired a special meaning, are to be taken in that sense. (American and English Encyclopedia of Law, 2nd Edition, vol. 26, p. 606), and cases cited.

The Revenue Acts of 1916 and 1917 deal with cor-

porate and individual net income and the ascertainment thereof. They necessarily embody sound business principles and practices as expressed in accounting science. In various sections of the Act are found words and phrases which have no significance except in accounting, *i. e.*, "paid in surplus," "earned surplus," "fiscal year," "net income or profits," "invested capital," etc. Such is the phrase "*most recently accumulated undivided profits or surplus.*"

The law itself recognizes that net income shall be determined by standard and customary accounting methods. [See Sec. 8 (g) 1917 Act; Sec. 212 (b) of the 1918, 1921 and 1924 Acts.] In the Regulations of the Treasury Department it is said "approved standard methods of accounting will ordinarily be regarded as clearly reflecting income." (Reg. 45, Art. 23; Reg. 62, Art. 23; Reg. 65, Art. 23.)

Further than this, the subject matter of Section 31 (b) is a technical one. It deals SOLELY with corporations and the distributions of their accumulations among shareholders and the allocation of the source of the distribution for tax purposes. The subject matter is *corporate finance as reflected in corporate accounts.* Corporations are artificial creatures of the law, and the ascertainment of their capital, surplus and net profits through the medium of corporate accounts is a highly technical subject.

The Treasury Department recognizes this. See opinion of the Advisory Board reported in Cumulative Bulletin, December, 1919, pages 294-5. It says:

> "The term 'earned surplus and undivided profits,' used in both acts is brief but full of import. *In effect, it incorporates into the law by reference, the*

entire body of principles of accounting relative to the determination of surplus."

It follows that Congress, in employing the words "accumulated undivided profits or surplus," adopted special phrases borrowed from business and accounting, and was using them in reference to a subject-matter as to which they had acquired a new and exact meaning. In construing the statute, therefore, they must receive that recognized meaning.

Accounting authorities agree that the words "accumulated undivided profits or surplus" of a corporation can only be determined at the close of a fiscal period by a proper balancing of its books and the determination of its liabilities, and that therefore this phrase cannot include current earnings at any intermediate period.

Col. Robert H. Montgomery, well-known author of various works on taxation and accounting, says in his "Auditing Theory & Practice," 1916, pages 199 and 206:

> "The surplus of corporations should represent an actual surplus; that is, a balance of net profits after all reserves have been provided for."

And again:

> "The net profit of a business is surplus remaining from the earnings after providing for all costs, expenses and reserves for accrued or probable losses."

In "The Science of Accounts," 1911, pages 24-25 by Harry C. Bentley, it is said (italics ours):

> "In the case of a corporate business, the balance

of Profit and Loss Account is transferred to Surplus Account *at the close of each fiscal period.*"

* * * * * * *

"From the foregoing discussion it would be seen that *accumulated undivided profits are surplus.*"

Kester in "Accounting Theory and Practice," Vol. 2, page 298, it is said (italics ours):

"The determination of profits rests upon a comparison of assets and liabilities *as at the beginning of a fiscal period with those at the end of a period.*"

In Patson & Stevenson's "Principles of Accounting," page 298, it is said (italics ours):

"In practice an intermediate surplus account, *undivided profits* is sometimes used. *Such an account receives any income balances which are not to be withdrawn at the end of the current fiscal period but which may become the basis of dividends in later years.*"

In W. H. Bell's "Accountants' Reports," at page 106:

"It occasionally happens that a commercial corporation sets aside a certain amount of profits as fixed surplus, designating that amount as *surplus* and the remainder as *undivided profits.* It is analogous to the paid-in surplus of a financial institution, as distinguished from its undivided profits."

See also the Opinions in this Court already quoted (pp. 29-30 *supra*), for a recognition and use of these phrases as defined above.

In the Year Book of 1911 of the American Association of Public Accountants, page 124, it is said, surplus

"in the restrictive sense means *accumulated undivided profits.*"

(c) The statutes of the states regulating corporate distributions and dividends.

For instance, Section 28 of the New York Stock Corporation Law provides that:

> "the directors of a stock corporation shall not make dividends, *except from the surplus profits* arising from the business of such corporation."

(See also Section 664 of the New York Penal Law.)

Most of the State Statutes contain similar provisions, which are simply a recognition of the principles above set forth.

As the Court said in People *ex rel. Jamaica Water Supply Co.* v. *State Board of Tax Commissioners,* 128 App. Div., 13, 17:

> *"The net income of a corporation for dividend purposes cannot be determined until all taxes, depreciation, maintenance, and upkeep expenditures have been deducted. Otherwise, the dividend is not paid from the earnings, but by depreciation of the capital account."*

(d) Other parts of Revenue Act of 1917 in which Congress used the words "surplus" and "undivided profits" as contrasted with and exclusive of intermediate current earnings.

It is a cardinal rule of statutory construction that "a word or phrase repeated in a statute will bear the same meaning throughout the statute, unless a different intention appears." Sutherland's Statutory Construction, Vol. 2, Second Ed., p. 758.

A few examples of a similar use of these words elsewhere in the act are as follows:

(1) *Sec. 3 of the Act of 1917.*

This section imposes additional taxes on stockholders of corporations organized for the purpose of evading the surtaxes. It provides:

> "BUT THE FACT THAT THE GAINS OR PROFITS ARE IN ANY CASE PERMITTED TO ACCUMULATE AND BECOME SURPLUS shall not be construed as evidence of a purpose to escape the said tax in such case unless the Secretary * * * shall certify that in his opinion SUCH ACCUMULATION is unreasonable for the purpose of the business."

Here Congress had in mind and appreciated the distinction between *earnings or gains* and *an accumulated surplus. "Gains and profits"* are contrasted with "surplus." In other words, it is only *"gains and profits"* that have been *"accumulated"* that *"become surplus."* Congress clearly recognizes that "gains and profits" which are not finally determined but only in a formative state, such as current earnings liable to be dissipated or reduced by subsequent charges, are not "accumulated" and have not *"become surplus."*

(2) *The words "undivided profits" which as used in Section 207 of the Revenue Act of 1917 defining invested capital furnish another instance and support respondent's contention.*

The Government refers to Section 207 of the Revenue Act of 1917, defining invested capital. It says that the words "undivided profits" are used as indicating the current earnings of the taxable year, and that therefore un-

der the rule of construction already cited a similar meaning must be attributed to the same phrase, used in Section 31 (b) (Petitioner's Brief, pp. 42, 43).

Section 207 does not support this argument. Under the Excess Profits Tax, which first appeared in the Revenue Act of 1917, it is the ratio of net income to statutory invested capital that determines the corporate tax rate. At the date when these two quantities, *i. e.*, net income and invested capital of the corporation, are to be computed, the fiscal or taxable year has closed, the corporate net income has been determined, the books balanced and all proper debits for the year made thereto, and any balance of profits transferred to surplus account. Section 207 defined invested capital of a corporation as including "(3) paid in *or earned surplus and undivided profits used or employed in the business.*" Had the Act stopped there, it might well have been claimed by corporations that there should be included in the computation of statutory invested capital the surplus earned during the taxable year and arrived at by the closing of the books at the end thereof; in other words, that the invested capital was that shown by the balance sheet at the *end of the year and not that at the beginning.*

Congress, however, did not so intend. It desired to exclude from the statutory "invested capital" the surplus or "undivided profits" earned during the taxable year and determined at its close. The Conference Committee, therefore, added to the above definition of invested capital the words, "*exclusive of the undivided profits earned during the taxable year.*" Congress here plainly used the phrase "undivided profits" in the sense of surplus as determined at the close of an annual period.

That this was the intention of Congress can be readily

shown by substituting in the statute for the phrase "undivided profits earned during the taxable year," the words "surplus earned during the taxable year and determined at the end thereof." With this substitution Section 207 has exactly the same meaning in defining invested capital. In each case it would definitely exclude from invested capital the surplus of the taxable year which was the intention of Congress.

Here again Congress used the words "undivided profits and surplus" in the sense adopted by the Court below.

III.

The arguments of the learned Solicitor General are unsound.

In an attempt to persuade this Court to accept his strained construction of the words "most recently accumulated undivided profits or surplus," contrary to the clear intent of Congress and their well settled meaning, so as to include current earnings, the learned Solicitor General has advanced a number of detailed and ingenious arguments, which, as we believe, on analysis can be shown to be fallacious. While it will be impossible, within the limits of this brief, to answer all of these arguments in detail, we wish to bring a few of them to the attention of this Court. We contend that

(a)

The section of the Revenue Act of 1917 under construction here is a statute imposing taxes, not an exemption clause.

The Government claims that the statute creates "exemptions" as to which the rule of strict construction against the Government does not obtain (Brief, pp. 18-22).

The Government claims these distributions should be taxed at the 1917 rates. The Court below held that these distributions under discussion were paid from the 1916 funds and bore the 1916 tax rates. As the Government says (Brief, p. 12), *"the only question now presented is at what rate shall they be taxed."* To argue that the taxpayer is claiming "exemption" from taxation seems to contradict this statement.

Section 31 (b) is, however, the Act imposing taxes not exempting therefrom. It classifies taxable income in dividend form and levies different rates thereon. The Government's argument seems to be that taxpayers who claim a lower classification under a statute levying different rates on different classes of taxpayers seek an "exemption," and that the act, if doubtful, is to be construed strictly against them. If this is correct, every taxpayer who claims a lower surtax bracket under the Income Tax laws would be asserting an "exemption" *pro tanto.* But this is tantamount to raising a legal presumption that all taxpayers are in the highest bracket unless the act shows clearly to the contrary—a subversion of the well-settled rule of construction applied to tax laws.

There is another answer to this contention. At most the words of Section 31 (b) allocating these dividends to the surplus of prior years are not clauses of exemption but "words of exception" or limitation reducing the application of the maximum tax. It is well settled law that such words, like all other sections of a taxing act, are to be given a liberal construction against the Government and in favor of the taxpayer. *Eidman* v. *Martinez,* 184 U. S., 518 at 583 (Opinion quoted in Petitioner's Brief, p. 20).

The Merriam case (263 U. S., 179) quoted at page 17 of the Government's brief, involved an exception or limitation in the Revenue Act of 1917. This Act after defining the taxable net income, proceeded to except *"the value of property* acquired by * * * bequest." The question presented was the precise meaning of the word "bequest," the taxpayer claiming under the exception. This court applied the rule of strict construction against the Government and held that the word "bequest" must be given *"its literal meaning."*

(b)

The use of the words "earnings or profits accrued" in the proviso 31 (b) in no way weakens Respondent's position.

The Senate passed 31 (b) exactly as set forth above, with no proviso. The Conference Committee, however, not only changed the entire scheme of Section 31 (b) by allocating dividends solely to "the most recently accumulated undivided profits or surplus," but deliberately struck out the provision allocating them to the "net income of the year when paid," and the provision making them income of the shareholder for the year when earned by the corporation, and added the proviso above referred to:

> "But nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribu-

> tion made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen."

The Government contends (Brief, pp. 45-7) that the words "earnings or profits accrued" in this proviso necessarily extend or enlarge the meaning of the former phrase "accumulated undivided profits or surplus."

Although it is not necessary for this Court to determine the meaning of the proviso, because the Circuit Court of Appeals held that the dividends in question were paid out of the "ample" 1916 surplus, several answers to this argument may be suggested:

(1) *Under the construction of the allocation rule contended for the Solicitor General, the proviso was redundant, except perhaps in its application to 1913 surplus.*

If, as the Government claims, the allocation rule in the first part of Section 31 (b) required corporations paying dividends first to exhaust current earnings of the year before surplus of prior years, the proviso was unnecessary. For the allocation rule in itself would lead to exactly the same result as the proviso, viz.: It would require a distribution of 1917, 1916, 1915, 1914 and 1913, (after March 1, 1913) earnings before the distribution of earnings accrued prior to March 1, 1913. In other words, if dividends are to be allocated first to current earnings, then the allocation rule and the proviso leads to exactly the same result.

And so the Solicitor General's argument leads him to the position that the radical changes in the statement of the allocation rule and the addition of this elaborate proviso by the Conference Committee, were surplusage and added nothing to the meaning of the bill as it passed.

(2) *The meaning of the apt phrase of the allocation rule cannot be enlarged by the words of the proviso.*

It is well settled, however, that the appropriate office of a proviso is to restrain or modify the enacting clause, and not to enlarge it (*Cyc.*, Vol. 36, p. 1162, and cases cited).

See also Sutherland Statutory Construction, Vol. II, p. 814, as follows:

> "It is a principle of statutory construction everywhere recognized and acted upon, not only with respect to penal statutes, but to those affecting only civil rights and duties that where words particularly designating specific acts or things are followed by and associated with words of general import, comprehensively designating acts or things, the latter are generally to be regarded as comprehending only matters of the same kind or class as those particularly stated. They are to be deemed to have been used, not in the broad sense which they might bear if standing alone, but as related to the words of more definite and particular meaning with which they are associated."

(3) *Admitting for the sake of argument that "earnings or profits" accrued have a different significance from the "most recently accumulated undivided profits or surplus," several explanations may be suggested.*

For example, the proviso may relate solely to that portion of the fund "most recently accumulated undivided profits or surplus" which was "accumulated" in 1913. For as Congress intended to permit the distribution of a part of the surplus of 1913 tax free, the use of the words undivided profits or surplus, as to surplus accumulated in 1913 had to be changed and some other phrase substituted to express the fact that in applying the rule, the 1913 surplus had to be split or subdivided as of March 1, 1913.

Had the proviso not been inserted, the statute would have taxed at 1913 rates the entire surplus of 1913, when distributed, including the portion "accrued before March 1, 1913." But this was contrary to the clear intention of the legislators. So Congress probably inserted the proviso, and used the words "earnings or profits" therein, as more accurately stating its requirement that dividends allocated to the 1913 surplus should be first charged to that portion composed of "earnings or profits accrued" after March 1, 1913, before being allocated to prior funds.

(4) *But, even if the words "earnings or profits" in the proviso include current earnings as the Solicitor General asserts, the proviso does not become inconsistent with or qualify the allocation rule as construed by the Court below.*

Congress may well have been satisfied to permit in the first instance the distribution of the surplus accumulated prior to 1917, taxable at the lower rates of earlier laws, even before current earnings of 1917. But they may not have been content to allow the fund accrued prior to March 1, 1913, to be paid out tax exempt until the "current earnings" of 1917 were exhausted.

This readily explains the use of the different phraseology in the enactment ("accumulated undivided profits or surplus"), and in the proviso ("earnings or profits accrued").

Further evidence in support of this is found in the fact that the proviso was added by the same Conference Committee that struck out from the allocation rule all reference to current earnings or "net income of the taxable year."

Finally, it may be said that the interesting question of the exact meaning of the proviso raised by Solicitor General

is not before the Court in this case and need not be resolved here because the Phelps Dodge Corporation had ample surplus in 1916, from which to pay those dividends, and the Appellate Court has assessed them at 1916 rates.

(c)

The "results" characterized as "absurd" by the Solicitor General are not attributable to the construction of 31 (b) adopted by the Court below.

Much is made by the Solicitor General of certain "absurd results" that it is claimed follow from Respondent's construction of 31 (b). (Brief, pp. 48-54). Most of these as will be shown either do not exist at all, or arise solely from a misconception of our construction of the Act. Moreover Section 31 (b) as construed by the Solicitor, will lead to far greater inequalities and injustices among taxpayers. Giving to the Solicitor's illustrations, however, the full force claimed for them, what do they prove? Merely that THE REVENUE ACT OF 1917 DID NOT PROVIDE FOR ALL CONTINGENCIES.

The Act was passed under stress of the World War, levying taxes, strange in form and unheard of in amount, founded on untried principles and applicable to the complex structure of modern business life. As the Court of Appeals say: "EXPERIENCE DEMONSTRATES THAT, HOWEVER CAREFULLY FRAMED A TAX STATUTE RARELY, IF EVER, CAN BE DRAWN WITH SUCH EXTRAORDINARY FORESIGHT THAT IT WILL PROVIDE FOR EVERY POSSIBILITY" (Record, p. 108, fol. 187).

That Congress, since 1917, has passed three new Tax Acts, seems to show this. (See Revenue Acts of 1918,

1921 and 1924, Amendment to Act of 1921, made March 4, 1923 Statutes.

Passing this, we submit that when analyzed, they do not support the Government's argument.

Three illustrations are given (Respondent's Brief, pp. 48-54).

(1) *Corporations closing their books semi-annually, quarterly or monthly.*

It is claimed that as under Respondents' construction this practice would determine "surplus," dividends thereafter declared would bear the higher 1917 rates, to the disadvantage of stockholders as compared with those of corporations who closed their books at the end of the calendar year 1917, thus making the rate of taxation depend upon the adventitious circumstance of how often the corporate books were closed (Brief, p. 49).

This argument entirely mistakes Respondents' contention. There is, and can be, under the Revenue Act of 1917 only one "surplus or undivided profits" of the corporation for a particular year, whether fiscal or calendar. This is the surplus arrived at by a balancing of the books *at the close of the year.* As shown, no partial or interim determination, of surplus or undivided profits short of the closing of the year suffice, or is permitted or considered under the 1917 Act and its Regulations. Income cannot be defined *except over a period of time,* and that period is prescribed under the law as one year. Congress adopted *yearly rests.*

The entire structure of this and subsequent Federal Income Tax Acts rests on the foundation of a yearly period. It would be wholly inconsistent with this system of taxation that "the surplus" and "undivided profits" to which

Section 31-b attributed distributions should be determined on any other than a yearly basis. The intention of Congress as manifested in the Section, required it. It was the purpose to permit distributions of the yearly accumulations of surplus and make them taxable for the distributee "at the rates prescribed by law *for the YEARS in which such profits or surplus were accumulated by the corporation.*" *The "undivided profits or surplus" referred to, were, therefore, an annual undivided profits or surplus, not a surplus of any shorter period.* How could it be told whether such surplus was accumulated "in" any given year until the year ended? The mere closing the books semi-annually did not determine that the apparent "surplus" shown thereby was real nor that it would be "accumulated" in that particular year. The closing of the books short of the end of the fiscal year could not determine the *annual surplus.* It could not determine anything, because the apparent surplus thereby established might be wiped out or diminished by losses or charges in the second period. It would be no more than an estimate of what the final surplus would be.

The Solicitor General seeks to meet this argument by asserting that "there is no reason to suppose that because the Act contemplates an annual system of taxation it must have contemplated an annual closing of books" (p. 62). This is almost a contradiction in terms. If, under the structure of the Act the corporation's accounts, such as its net income, its depreciation, its depletion, its inventories, its losses are entirely placed upon an *annual basis,* what argument can be advanced against a similar determination of surplus or undivided profits? An annual closing of the books is imperative under this law. It requires of the corporation an annual return. Whether it closes

its books oftener is not material. *The only financial status of the corporation with which this Revenue Act is concerned is that disclosed by the "annual closing of books."* Why should Congress place everything else on an annual basis except the "surplus" to which dividends were to be attributed under Section 31 (b)?

It should be noted that the books of Phelps-Dodge are closed annually and therefore this question does not arise in this case.

The next illustration of the Solicitor is that of

(2) *"Corporations whose fiscal years close in the earlier months of the year."* (Petitioner's Brief, p. 50.)

Counsel imagines certain inequalities that might occur by reason of "distribution to stockholders of corporations which ended their fiscal year in April, July or October" (Brief, p. 5). These, it is claimed, would be taxed at far higher rates than the stockholders in corporations with calendar years. This is not true. The stockholders in such corporations would merely pay at an earlier date their taxes on the war funds accumulated in 1917. The stockholders in the corporations having a calendar year ending December 31, 1917, would have to pay similar high taxes when this fund was paid out in 1918, or "subsequent years."

The Solicitor General argues that this is not sound because in 1917 stockholders would still "be taxed at unduly different rates depending on the bookkeeping methods of the corporation" (Brief, p. 50). This would not be so under the Respondent's construction for two reasons:

First, the rate of tax applicable to any dividend was made under 31 (b) to depend on the fund from which paid. If the surplus was earned in the earlier years it

bore the earlier rate. If earned in 1917 or later years, it bore the high war taxes. *But the year when the surplus was earned, not the date of distribution thereof, determined the tax rate. No bookkeeping methods of the corporation could alter that rate.*

Corporate action, including its determination of the date when it closed its financial year, as well as resolutions of directors declaring the dividend, might have a material bearing on the date when a particular fund burdened with the tax rate of the year when "accumulated" was *distributed* and, therefore, might accelerate or retard the date of payment of the tax incident to the fund. But it could have no effect *on the rate of tax.*

Second, The Revenue Act of 1917 permitted corporations to adopt a yearly period that ended during the year. These were known as "fiscal years" as contrasted with calendar years.

The necessary result of this was certain differences in the tax rate applicable in the year 1917 to corporations and their stockholders having the "fiscal," as distinguished from a calendar year. For example, a corporation having a fiscal year ending June 31, 1917, with $100,000 earnings during the first six months of 1917, would pay heavy war taxes, although in the next six months it lost more than $100,000, whereas had the corporation kept its books on a calendar year basis it would have paid no war taxes in 1917. Similarly, the fiscal basis raised difficult problems of apportionment of the corporate taxes between the two years 1917 and 1916 for which no rule was provided in the 1917 Act. The difficulties sought to be raised by the Solicitor General under this head, are only inherent in these corporate "fiscal" years.

(3) *Corporations having no surplus of 1916 or prior years, but current earnings in 1917.*

Two illustrations are given, (a) a corporation that had on hand no surplus accumulated at any time in the past, but as a result of the war made large profits in 1917, and (b) one not organized until 1917 that made large profits in 1917. Both make distributions to stockholders in that year. The Solicitor General claims that respondent must take the "absurd position" that these profits are not taxable, or admit that the words "accumulated undivided profits or surplus" in Section 31 (b) include interim current earnings (Brief, pp. 52-53). This does not follow; for under the construction adopted below dividends were attributed to prior *surplus.*

The rule requiring that distribution should be charged to a certain fund necessarily posits the existence of such fund. The fund failing, the rule does not obtain. If the corporation had no prior surplus, the rule ceased to operate, but it does not follow that the distributions were tax free.

The general law laid down by this Court in *Lynch* v. *Hornby* (247 U. S., 339), and the definition of taxable income in the Act [Section 2 (a) of the Revenue Act of 1916 (39 Stat., 756, 757, as amended by Section 1200 of the Revenue Act of 1917, 40 Stat., 329] provide that dividends paid by a corporation were taxable income to the stockholders in the year when received. The 1917 tax rates would be applied to these distributions in the two cases under discussion, not because of any allocation rule of Section 31 (b), but because it did not apply, and, therefore, Section 2 of the Act applied. It does not follow, however, from this admission that "the words most recently accumulated undivided profits or surplus do or

may include current earnings" as the Solicitor General claims (Brief, p. 53).

Again, the Solicitor General's argument proves too much and leads to conclusions equally "absurd." If the construction of the Act he claims be adopted, the two illustrations he cites might lead to the taxation of a capital distribution as income.

If a corporation organized in 1917 had made large "current earnings of $100,000" up to June 30th, 1917, and declared a dividend of that amount on that date, under the Government's claim those dividends would conclusively be charged to that fund and be taxed as 1917 income to the stockholder. But if in the next six months the corporation lost $100,000, what position does the Solicitor General take? He can take only one of two positions. First, to admit that the words "accumulated undivided profits or surplus" in Section 31 (b) are not synonymous with "current earnings" to the dividend date, but mean only *such* current earnings provided they ripen into a real surplus by a closing of the books at the end of the year. This, however, is to abandon his construction.

Second, to insist on his position that the words of 31 (b) mean "current earnings to the dividend date," would lead to the taxation as income of a capital distribution.

He cannot avoid this dilemma by claiming that the loss occurring in the second half of the year is chargeable to capital. Under the Revenue Act of 1917, all losses are chargeable to the current earnings of the entire year. (See Section 5 (a) Fourth (1) permitting deduction of "losses actually sustained *during* the year").

It can be readily shown aside from this that

(d)

The construction of 31 (b) contended for by the Government leads to "absurd results."

(1) *If under Section 31 (b) dividends are to be charged to the year's "current earnings," this would render the corporate excess profits tax levied thereby wholly indeterminate.*

The dividend allocation rule of 31 (b), however construed, controls in the determination of the Corporate "Invested Capital" under the 1917 Act. The Solicitor General so argues (Brief, pp. 16, 56) and the Treasury has so ruled (see Reg., p. 33, Art. 107, pp. 59-61).

Under the Government's construction of 31 (b) dividends must first exhaust "current earnings" to the dividend date, and any excess be charged to prior surplus—thus reducing *pro tanto* the corporate "Invested Capital," which under the Act included that prior surplus. [See Sec. 207 (3)]. But in fixing the amount of these "current earnings" to the dividend date, the corporation is required under the law and regulations to set up a reserve for Federal taxes, both Income and Excess Profits. However, the Excess Profits Tax is a function of both net income and invested capital, and can only be arrived at after an accurate determination of both factors.

The less the invested capital the greater the tax. Any deduction that tends to reduce the invested capital increases the tax. From this it follows that any item that increases a deduction from prior surplus, which is part of the invested capital, increases the tax. But the less the current earnings available for the distribution at any date the greater the excess chargeable to prior

surplus and the less the invested capital and the greater the tax. In the determination of the current earnings the tax itself is a factor or deduction.

Thus the Excess Profits Tax depends on the invested capital, which in turn depends on the prior surplus. But this prior surplus depends on the amount of distribution during the year chargeable thereto. Under Government's contention, however, the amount of these distributions chargeable to prior surplus depends on the amount of current earnings available at that date. And these available current earnings could only be determined by deducting the tax itself. This makes the tax depend on itself.

A vicious circle, in which the Excess Profits Tax is made to depend on itself, as this tax enters into and is made a factor of the calculation of the tax itself. It may be that higher mathematics furnishes a formula by which an approximation of the tax may be made, but it is still indeterminate. A fact the Regulations admit, see Reg. 62, Article 857. Mr. Montgomery in his Excess Profits Tax Procedure, 1921, page 266, referring to this anomaly says:

> "This calculation would require the use of an algebraic formula."

But as was well said by this Court in *Edwards* v. *Slocum*, 44 Sup. Ct., 293:

> "The Government offers an algebraic formula by which it would solve the problems raised by the two mutually indeterminates. It fairly may be answered as said by the Circuit Court of Appeals that 'algebraic formulae are not likely to be imputed to legislators' but it appears to us that the structure of the statute is sufficient to exclude the imputation.
>
> "As further remarked below the theory departs from the long established practice of the law not to regard the incidence of a tax in the levying of a tax."

It is needless to point out that under respondent's construction no such absurdity can arise. As all the distributions would be charged to prior surplus irrespective of the amount of current earnings, the Excess Profits Tax need not enter into the computation of invested capital. The ensuing tax would be definite and calculable. Perchance this is why the Conference Committee struck out the provision in the draft of 31 (b) allocating dividends to "*net income of the taxable year.*"

Another argument against the Government's construction is

(2) *If the presumption raised by 31 (b) is held to charge dividends to current earnings at the distribution date, that section lays down a rule inconsistent with Section 10 (b) of the same statute.*

Section 10 (b) reads:

> "In addition to the Income Tax imposed by subdivision (a) of this section there shall be levied, assessed, collected and paid annually an additional tax of ten per centum upon the amount, *remaining undistributed six months after the end of each calendar or fiscal year, of the total net income of every corporation, joint stock company,* or association, or insurance company, received during the year, as determined for the purpose of the tax imposed by such subdivision (a), but not including the amount of any income taxes paid by it within the year imposed by the authority of the United States."

It was the clear purpose of Congress by this Section to compel corporations to distribute the surplus of prior years within six months after the end of the corporate year. Yet if dividends declared in each year are to be conclusively attributed by Section 31 (b) to intermediate cur-

rent earnings, and if the amount of these can only be estimated and not known until the end of the year, how can the corporate directors during the first six months of the year be sure that they are distributing this surplus of prior years? Whether or not they had complied with Section 10 (b) and so avoided the additional penalty tax of 10% imposed thereby, depended entirely on the accuracy of the estimate of the current earnings up to the dividend date. If the estimate of current earnings proved too little, the penalty tax of Section 10 (b) would be imposed on the prior excess surplus not distributed. If the estimate proved too much, the directors might have unwittingly paid out the corporate capital.

Thus the imposition of the penalty depended entirely on an estimate of current earnings, that might prove inaccurate.

(c)

The statement in a report of the Ways and Means Committee of the House, made eleven months after the passage of the 1917 Act, dealing with a different revenue bill, is neither appropriate evidence nor a reliable guide to the meaning of 1917 law.

The Government's argument founded on such a statement (see Brief, pp. 35-37) is unsound.

In the first place, it is on its face an inaccurate and careless statement, and does not even correctly state the law as construed by the Government (Reg. 33, Art. 107).

In the second place, under the decisions of this Court such a statement is not evidence that will be considered in arriving at the meaning of an enactment.

See *Sutherland Statutory Construction*, 2d Ed., Sec. 470, p. 879;
United States v. *Trans-Missouri Freight Association*, 166 U. S., 290, 318;
United States v. *St. Paul Ry. Co.*, 247 U. S., 318.

In so far as it discusses the 1917 Revenue Act, this statement is a pure "*post mortem*" opinion of a committee in charge of an entirely different bill. It could not have in any way affected the passage of the 1917 Law; nor is there any evidence that it was acquiesced in or in any way affected the passage of the proposed 1918 Revenue Act. In other words, so far as the 1917 Law goes, this statement falls with the reason of the rule which excludes debates in Congress. As this Court said (166 U. S., at 318 *supra*):

> "The reason is that it is impossible to determine with certainty what construction was put upon an act by the members of a legislative body that passed it by resorting to the speeches of individual members thereof. Those who did not speak may not have agreed with those who did; and those who spoke might differ from each other."

(f)

The financial needs of the Government due to the entry into the war do not militate against but support the Respondent's construction of 31 (b).

It is urged by the Government (Brief, p. 59), that it is inconceivable that Congress under the most urgent need for tapping all available sources of revenue in order to carry on the war, should decide to forego one of the largest and most fruitful of such sources, and should

leave practically untaxed the large war profits coming to individuals through dividends declared and paid in 1917, the Government claiming that this would result from respondent's construction of 31 (b). This argument is many times repeated throughout the Brief (pp. 22, 24, 53, 54, 59, 60), but is not sound.

Under respondent's construction new and otherwise unavailable sources of revenue were opened up to the Government and large funds released and made available for investment in Government Liberty Loans.

Let us visualize the situation in the fall of 1917. The Revenue Act was passed October 3, 1917. It imposed for the first time in history unbelievably high rates of taxes —on the individual—surtaxes up to 63% of his income plus 6% normal tax; on the corporation, excess profits taxes running up to 60% plus 4% normal tax. These excess profit taxes were in reality a surtax on corporations in advance of distribution and so amounted to a levy of the surtax at the source on corporate investments. It was a matter of extreme doubt among the legislators whether an attempt to tax so high a percentage of income would not defeat itself. Yet the Government was urgently in need of free available money in the hands of individuals in large sums for floating war loans. Congress had already floated the First Liberty Loan on June 15, 1917 of two billion dollars.

In the fall of 1917 and at the time Section 31 (b) was under discussion before the Committees of the Senate and the House, the drive for the Second Liberty Loan of three billion, five hundred million dollars had started and was in full swing. The loan was dated November 15, 1917, six weeks after the passage of the Revenue Act. The Govern-

ment was tapping every source to obtain subscriptions for this huge loan thereto.

One of the most "fruitful sources" was the large corporate undistributed surplus of prior years. Congress wished to induce the distribution of this surplus through dividends. If these could be distributed under such conditions that the stockholders were assured that they were not subject up to a 69% tax, they were immediately available for subscriptions to the Liberty Loan. *For it was the unprecedented sums obtained from the sale of these Loan bonds that produced the immediate funds needed by this Government to win the war.*

The excess profits tax was a new and highly complicated tax. It was unfamiliar and little understood.

If Section 31 (b) were so framed that it required, as the Government argues, the "current earnings" of 1917 to be first distributed before the surplus of prior years, corporate officers would be left in a haze. Only a few months of the year 1917 were left. No regulations explanatory of the Act were published until after Jan. 1, 1918. In this short time, directors would be required to estimate current earnings, then familiarize themselves with the new revenue law, estimate invested capital, and excess profit taxes that would have to be deducted in order to arrive at the net earnings available for dividends—an almost insuperable task. Yet until this was done directors could not know nor advise stockholders how much of the distribution was subject to the high surtaxes of 1917. The stockholder could not then tell the rate of his tax until the year 1917 closed.

But if directors, under the law, could freely declare dividends in 1917 out of the surplus of earlier years that would be taxable at the rates of prior years—the rule

became simple, easy of operation. The directors knew instantly from the corporate books the exact amount available for distribution—and in what year earned. Stockholders familiar with prior tax laws knew precisely the rate of tax paid for those prior years. They knew, therefore, what part of these dividends was taken for taxes and what part was free for investment in war loans.

For this reason Congress struck out all reference in the section to net income or current earnings of the taxable year—and substituted the simple, practicable and workable rule of Section 31 (b) for which we contend.

Under our construction of Section 31 (b) any dividend declared after Jan. 1st, 1918, just three months after the passage of the Revenue Act—would be charged to 1917, surplus and bear the high 1917 rates of tax.

So the only right to levy maximum taxes that Congress saw fit to postpone under the respondent's construction was on the distribution of the 1917 profits during the last three months of 1917. In other words, it did not require that these 1917 war profits should be distributed and taxed in the year 1917, but they paid the full 1917 tax when distributed in 1918.

(g)

The Government's definition of surplus does not help its construction of 31 (b).

The Solicitor General claims (Brief, Point III, p. 38, *et seq.*) that surplus has a "well established meaning far broader than this alleged technical meaning of 'Surplus Account,' namely, the excess of assets over liabilities and capital stock" (Petitioner's Brief, p. 38). Various quotations are made from standard works on accounting and

from legal authorities in support of this definition. "Surplus" in a generic or broad sense may have this meaning, but the argument based on any such definition proves too much. In this *generic* sense, "surplus" includes

A—*Earned surplus* which comes to the corporation through the medium of profits.

B—*Paid-in surplus* which is the amount actually paid in as such by the stockholders.

C—*Donated surplus* which may be given by some or all of the stockholders, and

D—*Appreciated surplus* arising through increased value of assets by re-appraisals.

So defined "surplus" would include in the allocation rule of 31 (b) *paid-in surplus, donated surplus,* or *appreciated surplus,* as above defined. A dividend distribution would, therefore, under this section, be allocated to paid-in surplus of later date than an earned earlier surplus—and would, in the hands of the stockholder, be taxable at the rates prevailing when such later surplus was paid in, and so attempt to tax a capital distribution, a position the Government does not take.

Further, the subject matter of Section 31 (b) dealt with "taxable" distributions or dividends by corporation. It sought to tax such distributions at the rate prevailing in the years when the distributed corporate funds were earned. The section did not attempt to deal with capital distributions or liquidating dividends. Therefore, Congress did not use the word "surplus" *simpliciter,* but qualified it by the word "*accumulated,*" and provided that when distributed to stockholders, the tax rate should be that prescribed by law for the years in which such profits or surplus were "accumulated" by the corporation. Accumulated means "heaped up, collected, brought together,

amassed." It must have used this phrase "accumulated surplus," in the sense of "earned surplus."

Another argument against the Government's definition of surplus is that corporations do not annually arrive at the surplus by a balancing of the intrinsic value of the assets against liabilities. Good accounting and business principles require assets be carried on the books at cost, less depreciation. The practical difficulties of an annual re-valuation of all the corporate assets have precluded its adoption.

Finally, in Section 31 (b) Congress was not referring to the general surplus which denoted the excess of assets over liabilities and original capital, which had *no definite period of accumulation,* but to the annual undivided profits or surplus account shown at the close of each year, to which could be applied "the rates prescribed by the laws for the years in which such profits or surplus were accumulated by the corporation," which is the yearly earned surplus.

(h)

Any inference drawn from the meaning of the word "profits" standing alone and divorced from the associated words and phrases in 31 (b) is of no avail.

The Solicitor General argues that any narrow construction of the term surplus that may be adopted cannot be applied to the word "profits" in Section 31 (b), "which is one in common use, unambiguous and primarily means 'pecuniary gain' in any business, transactions or investments or excess of 'sale price over cost'" (Brief, pp. 41-2).

Whatever general or broad meaning might be argued attached to "profits" alone, it cannot be given to the phrase "most recently accumulated undivided profits" in the Act. To attempt to do so, ignores the entire qualifying words and their well-settled meaning.

Under this argument, the addition of the words "undivided" to the word "profits" already qualified by the words "accumulated" in Section 31 (b) was tautological.

But the legislative body is not presumed to use meaningless language. Every word of a statute must be given signification and weight, see *Walter* v. *Duffy*, 287 Fed. Rep. 41; *Monroe Co.* v. *Riordan*, 280 Fed., 624, and the Government's construction violates this rule.

It must be presumed that when Congress selected and used phrases having a definite and exact meaning to the business world it did not intend to mislead and confuse corporate officers by using the phrases in some vague or general sense.

(i)

Certain contentions advanced by the Government discussed and answered.

(1) One argument advanced by the Government is that both the company and Dr. Douglas allocated certain of these dividends to the earnings of the year 1917 (Solicitor's Brief, p. 563).

The record discloses the contrary, to wit: (Plaintiff's Exhibit "H," p. 43), Plaintiff's Exhibit "O," p. 49). Dividends paid by the Phelps Dodge Corporation during 1917 (exclusive of the two depletion dividends), were charged to surplus of prior years (Exhibit H, p. 43, Exhibit O, p. 49, Exhibit N, p. 48).

It is true, that Dr. Douglas, in making up his income tax return in March, 1918, and the President of the Corporation, in a statement to stockholders, dated February 28th, 1918, attempted to attribute some of these 1917 dividends to current earnings of that year. These facts, however, do not show a regular practice of either the taxpayer or the Corporation, nor do they warrant the statement that there was a "contemporaneous construction" placed upon the Act in January, 1918. Before these statements were made, the Treasury Department had issued a Regulation (Article 107 of Regulation 33), which, erroneously as we claim, required taxpayers and corporations under the 1917 Act, Section 31 (b), to attribute dividends paid to the current earnings. Misled by this regulation, unwarranted by the law, stockholders and corporation directors attemped retroactively to attribute some of the dividends to current earnings. An effort to comply with an erroneous, official and mandatory requirement cannot be twisted into a practical construction of the Law that may be used against these stockholders or corporations in asserting their rights in court. Likewise the fact that Phelps Dodge Corporation in its return for 1917, did not deduct all dividends of years from its prior surplus, does not support any argument against our construction of 31(b).

As its taxes were not settled and as the proper interpretation to be placed on 31(b) was still open, the corporation naturally made the appropriate claims to protect its rights under either construction.

(2) The suggestion that the construction of 31 (b) was not properly raised by the pleadings (Brief, p. 59) is readily answered.

As the Circuit Court of Appeals said (Record, p. 109, fol. 189): *"We think however that the language both of the protest and of the complaint is sufficiently broad to put the question to issue and the record clearly indicates that the parties litigated this question as well as the capital income question and so desired and understood."*

(3) But it is argued the construction of this Section by the Bureau of Internal Revenue has been uniformly and consistently in accord with Petitioner's claims and "ought not to be overruled without cogent reasons" (Brief, p. 58, citing Regulations 33, Article 107).

The first answer is that if the respondent's construction of 31(b) is correct, the rulings of the Commissioner and the Regulations cited are unwarranted and illegal. As was said by Chief Justice Taft, in *Smietanka* v. *First Trust Co. and Savings Bank*, 257 U. S., 602-605, "this seems to us to graft something on the statute that is not there. It is an amendment and not a construction." The Treasury Deparment by regulation cannot enlarge a taxing statute.

Another answer is that there has not been shown any long previous consistent practice or ruling by the Department, now sought to be overturned at this late date. The Regulations cited were the very ones challenged by the taxpayer in this case and that provoked this litigation.

As the Circuit Court of Appeals said (Record, p. 108, fol. 188):

> "We have not overlooked the Treasury regulation (Article 107 of Regulations 33 Revised) which interpreted the statute substantially as defendant contends. We are also mindful of the rule that the regulations and practices of administrative departments are entitled to weight and serious consideration in

construing a statute; but opposed to this rule is the familiar one that it is for the courts to construe a statute and not the executive departments of the government, and where, as here, we are satisfied that the statute requires the construction which we have attributed to it, a Treasury regulation rises to no higher dignity than an expression of opinion. Certainly the reference to the overruled decisions of the District Court do not help Solicitor's point."

IV.

The construction adopted by the Court below is just to the Government and to the taxpayer.

The Government argues that our interpretation of Section 31 (b) will result in gross favoritism to stockholders who received dividends in 1917. This is an easy criticism to make of any tax law; for in a sense each such law does favor some taxpayer at the expense of others. We should remember, however, that Congress in this bill, passed in October, permitted those stockholders who had received March 1, 1913 distributions prior to August 6, 1917 to receive them absolutely tax-free; whereas stockholders in identically the same situation, who were unfortunate enough to receive similar distributions between August 6 and October 2 are taxable, and taxable, so the Government contends, at the high 1917 surtax rates, although at the time they received these distributions they were clearly non-taxable under the 1916 law then in force. It is a matter of common knowledge that the stockholders of many corporations benefited greatly by this August 6 cut off. Had Phelps Dodge declared one of the dividends in question a month earlier it would have been admittedly tax exempt under 31 (b).

It hardly lies in the mouth of the Government, in view of such inequity inherent in the law itself and in view of such results, to charge inequality and favoritism to the recipients of ordinary dividends.

The only construction which minimizes this result and diminishes this inequality is the construction contended for by the respondents, which while it taxes stockholders receiving such March 1, 1913, distributions after August 6, taxes them at the lower 1916 rates, as against similar distributions, tax free, made prior to August 6, and postpones for three months the impact of the 1917 surtax rates. Such a fairly moderate tax would also continue to encourage distributions of earnings accumulated since March 1, 1913, and so tend to fulfil further the purpose of the bill as stated by Senator Simmons, *supra.*

This is only one of many instances in which postponing for three months the impact of the 1917 surtax rates would avoid glaring injustice to the taxpayer. For many corporations had accumulated substantial amounts of surplus in 1916 and prior years, and it is a general custom that dividends are paid out after the close of business and when the books have been balanced. So it is matter of common knowledge that many large distributions of 1916 or prior earnings were made in 1917. Many such distributions were made before the high surtax rates of 1917 were ever thought of. If those high rates had been applied, there obviously would have been great inequality of taxation between stockholders who in 1916 received dividends out of the earnings of 1916 and prior years, and those who received the same class of dividends in 1917.

This construction is also fair to the Government. As we have said above, the scheme of 31 (b) in the 1917 law was continuing; it was to apply to distributions in

1917 "or subsequent tax years." Counsel for the Government have their thoughts fixed on a taxable year in which the tax rates are much larger than those of the preceding year. However, they should remember that even in 1917 it was hoped that taxes would soon reach their peak, and that in successive years there would be substantial reductions in tax rates. This hope, though somewhat deferred, is now in process of realization. That being the case, it is clear that if Congress had not changed the plan and scheme of Section 31 (b), dividends received in 1924 would have been taxed at the higher rates prevailing in 1923, and dividends received in 1925 at the higher rates of 1924. In this way the Government would now gradually be getting back what it may seem to have conceded to the taxpayer in the year 1917. As we have said above, the chief complaint of the Government is due to the fact that Congress saw fit to change this perfectly reasonable and fair plan after it had been in operation only one year.

Moreover the argument that the Government was as a whole losing taxes under the construction placed in 31 (b) by the Court below is not supported by the facts.

When it is realized that the smaller its invested capital for the year 1917, the larger excess profits tax a company would pay, and when one remembers the excessive tax rates fixed by the Excess Profits portion of the 1917 Revenue Act, it is clear that any construction of the law which would cut down invested capital would be greatly to the advantage of the Government. Our construction of 31 (b) would have exactly that effect. For with Section 207 forbidding the inclusion in invested capital of the earnings of 1917, and with Section 31 (b) directing that 1917 divi-

dends be charged against the December 31, 1916, surplus, the necessary result would be to diminish that surplus by the amount of such dividends, and to diminish invested capital accordingly, with the result of a greatly increased tax to the Government.

CONCLUSION.

For the foregoing reasons the judgment of the Circuit Court of Appeals for the Second Circuit was correct and should be affirmed.

Respectfully submitted,

MATTHEW C. FLEMING,
ARCHIBALD DOUGLAS,
PAUL ARMITAGE,
EDWARD HOLLOWAY,
Of Counsel.

April, 1925.

FILED
OCT 26 1925
WM. R. STANSBURY
CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1924

No. [redacted] 129

WILLIAM H. EDWARDS, Collector of Internal Revenue
Petitioner

against

ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased
Respondents

On Writ of Certiorari on Summary Docket
Argued April 17, 1925

SUPPLEMENTAL BRIEF

Filed by Respondents by Permission of the Court Discussing a Third Suggested Construction of Section 31b of the Revenue Act of 1917

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1924.

No. 524

WILLIAM H. EDWARDS, Collector of Internal Revenue,
Petitioner,

against

ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased,

Respondents.

SUPPLEMENTAL BRIEF

Filed by Respondents by Permission of the Court Discussing a Third Suggested Construction of Section 31b of the Revenue Act of 1917.

Statement.

The question presented is, at what rates are certain distributions made by PHELPS DODGE CORPORATION in the year 1917 to JAMES DOUGLAS, one of its shareholders, taxable. This involves the construction of Section 31b of the Revenue Act of 1917 (see pp. 2 and 3 of Respondents' Main Brief).

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This act provides that corporate distributions made during 1917 should be attributed to "the most recently accumulated, undivided profits or surplus * * * and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation."

The distributions in question were intermediate distributions made by the corporation before the close of the calendar (its fiscal) year.

The Government's Construction.

The Government contended that this phrase, "most recently accumulated, undivided profits or surplus" in the statute included the current earnings made during the corporate year, from the beginning thereof up to the time the distribution was made; that therefore, there must be determined in each case of an intermediate distribution, as here, the amount of the current earnings of the corporation to that date, and that the distribution must be in the first instance attributed to such estimated portion of the current earnings to the amount thereof, and *pro tanto* bear the 1917 tax rates.

This construction was in accord with the regulations issued by the Treasury Department under this Act (Article 107, Regulations 33 as revised, pp. 61 and 62, which Regulations are printed in full in the Petitioner's Brief at pp. 57 and 58). This Regulation provides in part:

> "Thus, if a corporation distributed dividends in 1917 such dividends will be deemed to have been paid from the earnings of 1917, and the recipient, if an individual, will be liable to additional tax, if any, and if a corporation, to income tax, at the rates for the year 1917, *unless it is shown to the satisfaction of the Commissioner of Internal Revenue that at the time such dividends were paid, the earnings up to that time were not sufficient to cover the distribution.*"

Following this Regulation it has been the consistent practice of the Bureau in administering Section 31b and also the Corporate Excess Profits Tax Law, to determine the current earnings up to the date of the declaration of the dividend and charge the dividend to those in the first instance to the amount thereof.

Respondents' Contention.

It was the respondents' contention that this phrase in Section 31b did not include the intermediate current earnings up to the date of distribution of the dividend, but meant the surplus and undivided profits accumulated and fixed at the close of the calendar or fiscal period, next preceding the date of the distribution, which in this case was December 31, 1916.

No other, or different constructions of this Section 31b save these two had been advanced by the respective parties to this litigation.

The Construction Discussed in this Brief.

During the respondents' argument of this case certain members of this Court suggested a third construction of Section 31b, *i. e.*, that the phrase therein, "most recently accumulated, undivided profits or surplus" referred to the surplus arrived at at the end of the corporate year *next following* (not preceding) the distribution date.

Under this construction the allocation of any intermediate distribution would be held in suspense until the closing of the books of the corporation at the end of the calendar year, and if a surplus was then disclosed (even though accumulated subsequently to the distribution date) all past distributions during the year should be charged to that surplus and bear the tax rates of that year.

Respondents' attorneys did not attempt to meet or answer this construction in the briefs filed herein, feeling that their briefs should not be overweighted with issues not raised, and therefore, have requested the permission to file this brief.

ARGUMENT.

POINT I.

The Congressional intention drawn from the legislative history of Section 31b shows conclusively that it was not intended to attribute intermediate distributions in 1917 to the future surplus accumulated at the close of the year.

The history of the 1917 Revenue Act and the various changes that occurred in this part thereof during its progress through the Houses and Committees of Congress are detailed in full in the respondents' main brief (see pp. 12 to 24). Suffice here to point out that in the Senate bill, as passed September 10, 1917, distributions were first deemed to have been made *"from the net income of the years in which such distribution is made or if such income is insufficient,* from the most recently accumulated undivided profits or surplus." In conference the italicized words were elided (see Respondents' Brief, p. 24). Had the Senate bill been passed unchanged, it would have expressed in most exact language the construction under discussion. Had the Senate bill become a law it would necessitate the holding in suspense of the allocation of the dividend until the end of the year when "the net income of the year in which such distribution was made" had been determined.

"The net income of the year in which such distribu-

tion is made" is necessarily surplus arrived at at the close of the year. Congress, therefore, by eliding all reference to this fund in the bill as passed, conclusively expressed its intention that intermediate distributions made in 1917 should not be so allocated.

It should be emphasized that in the Senate bill of September 10, 1917 the "most recently accumulated undivided profits or surplus" was to be resorted to only in case "the net income of the current year was insufficient." Clearly, therefore, it must refer to a surplus accumulated *prior to the current year,* not at the end thereof. This bill, therefore, demonstrates to a mathematical certainty that the meaning of the phrase suggested on the argument was never in the mind of Congress.

POINT II.

The context of Section 31b shows that Congress intended to allocate distributions to a fund already "accumulated" IN THE PAST and not to be thereafter determined.

Section 31b covered all corporate distributions both intermediate and those made after the close of the year. It covered "any distribution" made *"in the year 1917 and all subsequent years."*

It provided that these should be allocated or charged to "the *most recently accumulated* undivided profits or surplus." The phrase "most recently" qualifying the word "accumulated" gives it a restrospective significance. It plainly refers to the date of distribution and describes a "surplus" that was already in existence. This phrase can not be given a prospective meaning as referring to some future fund to be thereafter accumulated.

Had Congress intended that the dividends were to be

attributed to a future fund it would have used some such phrase as contained in the Senate Bill or a similar phrase showing unmistakably that intermediate distributions were to be charged in the first instance, *to the surplus of the year in which such distribution was made,* or if insufficient, then to the prior funds.

By no strained construction of the grammatical structure of 31b can it refer to any surplus accumulated *posterior* to the distribution date.

There is no reference in 31b to the subsequent filing of the tax return in March, 1918. Nor can the words "most recently" be held to refer to that date except by injecting into the statute a reference to that date. This would not be statutory construction but legislation.

POINT III.

The suggested construction defeats the manifest purpose of the Act as holding out an inducement to corporate directors in the year 1917 to declare a prior surplus at lower tax rates. If all distributions were held in suspense until the close of the year, neither the directors nor the stockholders would know at the time of declaration to what fund any intermediate distributions were to be charged or what tax rate they bore.

As a practical matter this third construction would nullify the Congressional intent. In most corporations the corporate surplus cannot be accurately determined until many weeks, if not months, after the close of the year. Directors and stockholders could not know, therefore, at the close of the year, the amount of this surplus. But any distribution made in the succeeding year under the suggested construction would have to be suspended until the surplus of that year also had been determined,

so directors and stockholders would for months if not years be in doubt out of which year's surplus the dividends were paid.

POINT IV.

This construction collides with the State statutes forbidding distributions to be charged or paid out of profits not in existence at the date thereof. If Section 31b required the allocation of such dividends to the future corporate surplus as established at the end of the calendar year, the corporate books might readily show a violation of the State laws (see Respondents' main brief, pp. 38-41).

POINT V.

This third construction of Section 31b renders the corporate excess profits tax wholly indeterminate.

The point that the Government's construction of Section 31b created a vicious circle making the excess profits tax depend upon itself and so indeterminate, was developed in respondents' brief, pages 54-56. It is only necessary here to point out that if intermediate dividends are attributed to the future surplus at the end of the year the same defect inheres in the law.

POINT VI.

Finally, this suggested construction is inconsistent with the construction placed upon 31b by the Treasury regulations and decisions and the ruling and practice of the Bureau of Internal Revenue in the administration of this law.

> (See Article 107 of Regulation revised, pp. 61-62, printed in full in Petitioner's Main Brief, pp. 57 and 58.)

The Solicitor General, after quoting this, states:

> *"This regulation has been followed by numerous Treasury decisions and rulings amplifying and explaining it and never at any time has there been any ruling or practice of the Bureau of Internal Revenue inconsistent with this regulation"* (p. 58).

The effect of adopting the third suggested construction would require a reversal of all these rulings and decisions by the Department. The fact that it had been estimated that there were or were not sufficient earnings at the distribution date would not warrant a similar conclusion at the end of the year. The earnings accumulated up to the distribution date may have been dissipated by subsequent losses or a deficit of earnings made up by subsequent profits. Therefore, this construction of 31(b) would require for the year 1917 a redetermination by the Treasury Department of the entire question of invested capital of corporations, as well as the tax rates applicable to stockholders.

Further, under this interpretation, the Government's argument, based on the long continued construction of this section by Treasury officials (see Petitioner's Brief, pp. 54-60) lapses.

We do not anticipate that the Solicitor General will

seriously urge a construction of 31(b) so destructive of the rulings and practice of the Bureau of Internal Revenue and so detrimental to his position before this Court. The very suggestion of this third construction only adds emphasis to respondents' argument that the statute is so ambiguous as to compel a construction most favorable to the taxpayer.

Gould v. *Gould*, 245 U. S., 151;
U. S. v. *Merriam*, 263 U. S., 179.

We submit, therefore, that the suggested construction of the Act discussed above is even more unsound than the one adopted by the Bureau of Internal Revenue in its regulations and administration of the law (Reg. 33, Art. 107, *supra*) and contended for by the Solicitor General.

Respectfully submitted,

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FILED
JAN 8 1926
WM. R. STANSBURY
CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM—1925

No. 129

WILLIAM H. EDWARDS, Collector of Internal Revenue

Petitioner

against

ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased

Respondents

On Certiorari to the United States Circuit Court of Appeals for the Second Circuit

PETITION FOR REARGUMENT

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PETITION FOR REARGUMENT 1

I.

By a combination of circumstances respondents' counsel were prevented from presenting on the oral argument the principal points relied upon by them in supporting the decision of the Court below 1

II.

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Certificate of Counsel 27

IN THE

Supreme Court of the United States

October Term—1925.

No. 129.

WILLIAM H. EDWARDS, Collector of Internal Revenue,
Petitioner,

against

ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased,
Respondents.

On Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

PETITION FOR REARGUMENT.

The respondents petition for a reargument of this case on the following grounds:

I.

By a combination of circumstances respondents' counsel were prevented from presenting on the oral argument the principal points relied upon by them in supporting the decision of the Court below.

The facts leading up to this result are these:

The Government moved to advance the case by reason of its importance in the administration of the Revenue Act and the rights of various other taxpayers affected by the decision. This Court of its own motion placed the case on the Summary Docket, thereby limiting the arguments to half an hour on each side.

Counsel for the Government presented his argument for the construction of the Revenue Act contended for by the Treasury Department almost without questioning by the Court. Hardly had counsel for the respondents commenced his argument when a member of this Court suggested a possible construction of the section of the Act under consideration for which neither party had contended. It was not only contrary to the Treasury Department's regulations and procedure, nor had it been suggested or referred to in any of the briefs or in the opinion of the Court below. When counsel for respondents pointed this out, the Chief Justice stated that as the construction was a possible one, respondents must meet it. Not having been discussed or referred to in the brief, counsel thereupon felt it incumbent on them to persent fully their arguments against this third construction, with the result that the balance of the very limited time allowed them was occupied in discussing this construction and answering various questions of the Court in reference thereto.

Counsel for respondents were so concerned over the importance the Court placed on this suggested third construction contended for by the Government, that they were led to discuss it in a supplemental brief which they filed.

The opinion in this case, however, shows that this suggested third construction was subsequently discarded and that the Court followed the argument of counsel for the Government in reaching its conclusions, unaided by practically any oral argument by counsel for the respondents on the main issues of the case.

Issues as complicated as those arising in this case and affecting the rights of many taxpayers should receive a full oral discussion. The same reasons which prompted this Court to grant the writ of certiorari—its importance in the administration of the revenue laws and its effect

upon many taxpayers—should now move it to grant a rehearing, where an adequate and full discussion of the issues involved and of the respondents' contentions may be had. We do *not* claim that in every case where a discussion occurs between the Court and counsel, occupying a substantial portion of the counsel's time, a reargument should be had; but that in a case of the complicated character of this one, an oral argument so limited as to permit only a discussion of collateral issues suggested by the Court and thus preventing any argument by the respondent of the real points involved, does not give the respondent a fair hearing. The Court, on a consideration of all the facts and circumstances surrounding the argument as set forth above, should, it is submitted, grant the respondent a rehearing.

That real injury has resulted to respondents, we believe, is manifest. An examination of the opinion will disclose that this Court entirely misunderstood or misconceived the forceful arguments supporting respondents' construction of Section 31 (b).

II.

That respondents have suffered material injury is evinced by the following points in the opinion of the Court:

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1. The ambiguity of the statute compels a resort to the legislative history of the Act.

The ambiguity of the statutory language is evidenced by the exhaustive discussion of its meaning in the opinion of the Court.

The opinion, however, through an evident misconception of respondents' arguments, is led to brush aside and

ignores the legislative history of the Act with the statement that there is no occasion to resort to "that aid in construing the phrase in question" as "to ascertain its meaning, we need only bear in mind the *general character of the income tax, the specific practices of corporations concerning profits and dividends, the prior income tax legislation to which Sec. 31 (b) is an amendment, and the time of the latter's enactment.*" Under what rule of construction are these last "aids to construction" given preference over the legislative history? They are all matters extraneous to the language of the Act. They are all farther afield from the Act itself than the legislative history; they are all admissible aids to construction only if the language of the Act is ambiguous. A resort to them necessarily implies an ambiguity in the language of the Act. But if such ambiguity exist, this Court has repeatedly held that the legislative history is a proper aid to construction. We know of no rule of construction which permits the ignoring of this aid to construction merely because other aids exist. Whether or not the legislative history of the Act here under construction is persuasive of the intent imputed to Congress by the respondents may be a question of judgment for the Court, after a consideration of such history. But we submit that, due to a misconception of respondents' arguments, the Court erred in refusing to consider the evidence at all.

The sole object of the study of statutory construction is an endeavor to discover the intention of Congress in its enactments. It is uniquely and peculiarly important and explanatory in this case, for the language of the Bill as it first passed the Senate exactly and clearly expressed the precise meaning now contended for by the Government; the words which expressed this meaning were stricken from the Act as finally passed, clearly evidencing that this was not the intended meaning. We submit that

a situation as strikingly interpretative as this should not be merely ignored—as this Court has held in the almost identical case of *Lapina* v. *Williams*, 232 U. S., 78, where Mr. Justice Pitney said:

> "The Senate inserted the word 'Immigrant' in one place but it was eliminated in conference. * * * Whatever considerations may have combined to bring about the judicial interpretation of the acts that preceded the revision of 1903, Committee reports already cited sufficiently show that the language of the new act was chosen not for the purpose of adopting, but in order to avoid, that interpretation."

That the meaning of the "phrase in question" is not clear is indicated by the long discussion given to its meaning in the remaining part of the opinion of this Court. That it is ambiguous is distinctly stated by the District Judge in *Irwin* v. *Harder*, 285 Fed., at the bottom of page 408, where he says:

> "In the latter amendment, passed in 1918, Congress removed the *ambiguity* arising from the words '*most recently accumulated undivided profits or surplus*' in the statute of 1917."

And that the meaning of the "phrase in question" is not unquestionably that given to it in the opinion of this Court, and is at least open to doubt, appears clearly from the following quotation from the opinion in this case of the Circuit Court of Appeals (298 Fed., at p. 241):

> "The expression 'undivided profits' is for all practical purposes of this statute synonymous with 'surplus' and certainly with 'accumulated surplus.' It means such profits as exist and have or have not been ascertained, but, in any event, have not been distributed or otherwise used *and is distinguishable from current earnings or profits.*

> "It is a matter of common knowledge and, indeed, an obvious fact that *accumulated undivided profits or surplus cannot be ascertained without investigation or some appropriate method of accounting or calculation.*" (Italics ours.)

That seven Judges out of the thirteen who passed upon this case agreed with respondents' interpretation of the phrase establishes its ambiguity.

Certainly, here, if ever, is a case calling for some indication, *other than mere opinion,* of what Congress really did mean. Here, if ever, is a case requiring resort *to the acts which are part of the legislative history,* if any exist. And if that legislative history is consulted, we submit that the Court will find it to be compelling evidence of the correctness of the construction contended for by the respondent (see Point 10 below).

2. The opinion of this Court misapprehended respondents' argument with regard to the significance of the legislative history.

The Circuit Court of Appeals, before whom respondents had time to develop on oral argument their theory of the case, clearly appreciated the significance of the legislative history argument, as appears (298 Fed., 299) on pages 244 and 245 as follows (italics ours):

> "But, if any or all these suggestions are without merit, it is nevertheless clear, as matter of statutory construction, that it *was not intended,* on facts such as those in the case at bar, *that the shareholder should be taxed at the 1917 rate,* even though, because of the amount involved, 'it requires a struggle to resist the influence of the fact,' as was tersely said by Mr. Justice McKenna, in *Lynch* v. *Turrish, supra.*"

The opinion of the Court again says (298 Fed., at pp. 243 and 244) (italics ours):

> "While the Senate Finance Committee and the Senate intended that dividends declared in 1917 should be deemed to have been paid first from *such net income as might be earned in 1917*, it is plain that this program was not satisfactory to the Conference Committee. The result was that the part of the bill, italicized, *supra*, as passed by the Senate, was stricken out and 31 (b) was enacted in its present form."

and again at page 214 (italics ours):

> "The real point of this legislative history is that the legislature was not, in this regard, *dealing with current earnings*, and by the most obvious procedure, had *eliminated current earnings* from consideration as affecting the rate at which the taxpayer was to be taxed."

We contend that the Senate having on September 10 passed a bill which entirely and clearly supported the Government's theory in this case, and the Conference Committee and Congress having three weeks later struck out the very words which express this meaning and completely changed the wording of the bill, thereby clearly and emphatically intended to change the meaning.

For the convenience of the Court, we repeat the main provisions of the Senate Bill of September 10:

> "Any distribution made to the shareholders of a corporation * * * in the year nineteen hundred and seventeen, or subsequent years, shall be deemed to have been made *from the net income of the years in which such distribution is made, or if such income is insufficient*, from the most recently accumulated undivided profits or surplus."

It further provided that such dividends should be taxed at the rates prescribed for the respective years in which the income *was "earned* by the corporation."

It was absolutely clear from a reading of the above that on September 10 that the fund "most recently accumulated undivided profits or surplus" clearly could not include current earnings, but was a prior fund, defined and fixed at the end of some prior accounting period. The question arises, if that draft expressed the "aim" of Congress, as found by this Court, why, when the bill was finally passed, were the words which clearly gave it this meaning eliminated?

For, when the bill passed Congress on October 2, the words in italics were omitted, and Section 31 (b) read:

> "Any distribution made to the shareholders * * * of a corporation * * * in the year nineteen hundred and seventeen, or subsequent years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus * * * and shall be taxed at the rates prescribed by law for the years in which such *profits or surplus were accumulated.*"

The phrase in question, "undistributed profits or surplus" on September 10th clearly *excluded* current earnings. It was then clearly not synonymous with current earnings. How could it have become within the next three weeks (when the bill became law) synonymous with and inclusive of current earnings? Why, if Congress intended to allocate 1917 dividends to current income, did it not only fail to say so but strike from the bill the very words that did say so? Why, if the September 10 bill clearly expressed this "general aim" Congress had in mind, did Congress change this absolutely clear phrase so that on October 2 it became at least ambiguous? And why is an ambiguous phrase in a tax law construed against the taxpayer?

Surely the striking force of this legislative history must have been lost to the Court.

3. The linking in the opinion of the legislative history of 31 (b) with the history of the 1918 Act indicates a clear misapprehension of the legislative history.

In commenting upon the legislative history the opinion says:

> "The legislative history of Section 31 (b) is relied upon by the Douglas Estate in support of its construction. On the other hand, the Government relies upon the legislative history of the Revenue Act of 1918, Act of February 24, 1919 (c) 18, 40 Stat. 1057, passed by the same Congress which enacted the Revenue Act of 1917. Enquiries into the detail of legislative history are sometimes helpful in removing a doubt presented by the language used in a statute. *Penn Mutual Life Ins. Co.* v. *Lederer*, 252 U. S., 523, 537, but we have no occasion here to resort to that aid in construing the phrase in question."

The scant attention which it was possible for respondents' counsel to give to the history of the 1917 Law on the argument is undoubtedly responsible not only for the foregoing way in which the contentions of respondents and the opinion of the lower Court are treated, but also for the error of this Court in linking up the history of the 1918 Law as equally important with that of the 1917 Law. For it must be remembered that the Government's contention is simply that while the 1918 Law was pending in Congress, the Chairman of a Committee gave *his version* of what was enacted in the 1917 Law—a mere expression of personal opinion, and as it proves, one entirely at variance with the Government's own construction of the clause in controversy and which suggested a third construction and one

which this Court has declined to adopt. On the other hand, the respondents rely on *changes actually made* in the 1917 Law as it went from the Senate's Finance Committee to the Senate, as it passed the Senate and as it finally passed Congress. In other words, we rely on what *was done in 1917*, on acts which were a part of the *res gestae;* while the Government relies on a *post mortem* opinion of a man who, in 1918, states what he *thinks* was done in 1917. Perhaps this putting of the two contentions in the same category as of equal importance largely influenced the Court in its decision that it was not necessary to resort to the legislative history of the 1917 Act at all, "in construing the phrase in question."

4. The imputation to the respondents' construction of a resultant gross discrimination contradicts the very purpose of the section as stated in the opinion.

The opinion of this Court states that the respondents impute to Congress "the intention of grossly discriminating" in favor of stockholders of corporations which had on hand on January 1, 1917, surplus profits earned since March 1, 1913. Under the respondents' construction, it is stated,

> "stockholders in corporations which had no such surplus on December 31, 1917, are taxable on 1917 dividends at the high 1917 rates, while those in corporations which had such surplus are taxable on 1917 dividends at the lower rates of 1916 or earlier years."

We confess, this strikes us as indeed a curious statement. The opinion correctly states that the clear purpose of Congress was to tax dividends not at the rate of the year in which received, but at the rate of the year in which the profits of which the divi-

dends are a distribution were earned. It is the obvious and inevitable result of such arrangement that dividends from different corporations paid in 1917 may bear different rates. To this extent, Congress was, of course, and with express intention "grossly discriminating" in favor of some taxpayers. Not only is this true in the example cited in the opinion, but in its converse. Corporation A has no 1917 earnings but surplus accumulated in 1916. Corporation B has 1917 earnings but no previously accumulated surplus. Under either construction of the section, dividends paid by A in 1917 will bear the 1916 rate, while dividends paid by B in the same year will bear the 1917 rate. Has not Congress here "grossly discriminated" in favor of stockholders of A? But is there any possible question but that Congress intended such discrimination?

It must be borne in mind that the respondents' construction does not permit of the distribution of 1917 earnings—"war profits"—at other than the 1917 war rates. If this be the implication in the discrimination stated above, it is erroneous. The 1917 earnings, no matter when ultimately distributed, will bear the 1917 rate. In the example cited in the opinion, the stockholders of the corporation with a 1916 surplus would, under respondents' construction, pay the 1917 rate on all 1918 dividends up to the amount of the 1917 surplus. The later repeal of the statute may have defeated this purpose, but an intention to repeal the Act cannot be imputed to Congress at the time of its passage. The repeal has worked inequalities under any construction.

5. That which the Court says respondents graft upon the section is in fact expressly stated in the proviso of the section.

The opinion states that the respondents' interpretation—

> "grafts upon the section an implied condition or limitation. Its position seems to be that Section 31 (b) applies if, and only if at the time of payment of the dividend there was on hand an undistributed part of the taxable earnings of some prior fiscal year or years. In other words, it asserts that Congress, in providing that a distribution to shareholders should 'be deemed to have been made from the most recently accumulated undivided profits or surplus,' implied the condition—'if there are such accumulated profits or surplus not exempt from taxation'; that if there are available no such undivided profits or surplus, accrued subsequent to March 1, 1913, the distribution will be considered to have been made from current earnings."

The above statement wholly overlooks the proviso to Section 31 (b) which expressly provides that current earnings shall be distributed before tax exempt surplus. How, under the respondents' or any other construction, can it be necessary to imply a condition that "if there are available no such undivided profits or surplus, accrued subsequent to March 1, 1913, the distribution will be deemed to have been made from current earnings" when the proviso to the section expressly states that (italics ours):

> "but such earnings or profits [accrued prior to March 1, 1913] may be distributed * * * exempt from the tax, *after* the distribution of earnings, and profits accrued since March first, nineteen hundred and thirteen, has been made."

Here we have a clear and unambiguous statement in the section of that which the opinion states the respondents graft upon it as an implication.

In any event Section 31 (b) lays down a rule of allocation. Unless more than one source of distribution exist, no allocation rule is necessary, for no choice of allocation exists. It is an inevitable and obvious implication in every rule of allocation that alternatives are possible. It is this "condition or limitation" which the respondents graft upon the section. If a corporation has only current earnings and no prior surplus, obviously there is but one fund from which dividends can be paid and no allocation rule is necessary or applicable. If a corporation has current earnings and in addition only March 1, 1913, surplus, there is still only one fund from which dividends can be paid, for the proviso to Section 31 (b) forbids the distribution of the March 1, 1913, surplus under such circumstances, and no allocation rule is necessary or applicable. In either of these cases that part of the section which lays down the rule of allocation has no application, no allocation being possible.

6. The construction adopted in the opinion makes part of the section mere surplusage.

While imputing to the respondents the attempt to graft a condition upon the section, the opinion has wholly overlooked the elimination of an entire clause from the section, made necessary by the construction adopted. Under such construction, what possible use or meaning has the clause "but such earnings or profits (prior to March 1, 1913), may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and

thirteen has been made"? *Under such construction, the clause is wholly surplusage.* For, if dividends are to be applied first, against current earnings and then successively against earnings of previous years in order, as the Court finds, it is clear that earnings accrued to March 1, 1913, will be the last to be reached; and, in consequence, could not possibly be distributed until after the distribution of all earnings accrued since March 1, 1913. Why, then, did Congress enact the clause? If the surplus of previous years is to be deemed distributed before current earnings, March 1, 1913, surplus would be included in such prior distribution and a tax free distribution would thus be permitted before a taxable distribution. The clause was thus inserted to prevent this possibility. Under the respondents' construction the clause has this vital and important meaning. Under the construction adopted in the opinion, it is idle and meaningless surplusage. Only the most cogent of reasons can justify the imputation of such an intent to Congress.

The history of the Act lends force to the persuasiveness of this position. As originally passed by the Senate, the Act, which in its then form clearly expressed the construction contended for by the Government, did not contain this proviso clause. It was only when the bill was amended to its final form and the change was made effecting the change in meaning contended for by the respondents, that this proviso clause was added. If Congress had not intended a change in meaning, why did it add this proviso which is meaningless and superfluous unless such change was intended?

The full force of this situation was perhaps not made clear to the Court. The respondents in the discussion of this point in their brief, stated that the proviso to the section had a possible purpose, even under the Government's

construction, in dividing the undivided profits or surplus of December 31, 1913, into earnings accrued prior to March 1, 1913 and earnings accrued after. As the surplus accumulated December 31, 1913, would be taxable at the 1913 rate, it was possibly necessary to make clear that such part of the surplus as consisted of earnings accrued prior to March 1, 1913, should be tax free. This necessity, however, applies only to the first proviso, exempting prior to March 1, 1913, earnings from tax. It does not apply to the proviso under discussion providing for the distribution of such earnings tax free after the distribution of all subsequent earnings. There is only one possible reason for the existence of *this* clause with its different phrase of "earnings or profits" coupled with "undivided profits or surplus" of the main clause. But for its presence Section 31 (b) would permit the distribution of tax free surplus before the distribution of current earnings. If the section does not permit such distribution irrespective of this proviso, the proviso is pure surplusage.

7. The statement regarding the use of the term "undivided profits" conflicts with former statements of this Court.

It is stated in the opinion that the term "undivided profits" is not "a term commonly employed in corporate finance and accounting to designate an account on corporate books"; also that "few business corporations establish an 'undivided profits' account." And yet, in *Eisner* v. *Macomber*, 252 U. S., 189, 209, 210, this Court in discussing the fundamental nature and general methods of corporations, said (italics ours):

> "For bookkeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a 'capital stock account.' If profits

> have been made and not divided they create additional bookkeeping liabilities under the head of 'profit and loss,' '*undivided profits,*' 'surplus account,' or the like.
>
> "When only a part is available for dividends the balance of the year's profits is carried to the credit of *undivided profits,* or surplus, *or some other account* having like significance."

The opinion does not state "undivided profits *account*" but uses "undivided profits" as meaning such account. Parenthetically, Section 31 (b) does not couple the word "surplus" with "account" yet the opinion of the Court holds that "surplus" means the *surplus account.*

And Mr. Justice Brandeis in his dissenting opinion said, at page 232 (italics ours):

> "Many corporations, without legally capitalizing any part of their profits, had assigned definitely some part or all of the annual balances remaining after paying the usual cash dividends, to the uses to which permanent capital is ordinarily applied. Some of the corporations doing this, transferred such balances on their books to 'Surplus' account,—distinguishing between permanent 'Surplus' and the '*Undivided Profits*' account."

8. The argument based upon the action of the respondents in reporting the dividends reveals a misunderstanding of the Treasury Regulations and the record in this case.

The opinion relies upon "the action of both Douglas and his estate" as indicative of the true construction to be adopted. "Douglas received—during July 1917 six other dividends * * * which were confessedly paid out of the 1917 profits—and which were reported by him as taxable in his return to the Commissioner of Internal Revenue. The two dividends here in question were re-

ported by him in his return as not taxable solely on the ground that they were 'depletion dividends.' It was on this ground only that the estate, in its applications to the Treasury, sought recovery of the amount in suit." The *ad hominem* argument here relied upon can only be based upon a misapprehension of the Regulations of the Treasury Department as existent at the time of the acts in question, and of the record in this case. The respondents have always believed and contended until the decision of the Circuit Court of Appeals that the word "deemed" in Section 31 (b) raised only a rebuttable presumption. If such contention were correct, it is obvious the presumption was rebutted by the statement of the directors of Phelps Dodge Corporation that the dividends were out of 1917 earnings. Douglas was, therefore, bound by such statement under his understanding of the word "deemed" to return the dividends as out of 1917 earnings. His action is wholly inconclusive, therefore, in the present state of the case, with the word "deemed" raising an irrebuttable presumption.

If this Court chooses to hold that the word "deemed" simply creates a rebuttable presumption, we shall be content, for there is no question of what *was intended*. If, however, as the Government contends, and as the lower Courts held, this presumption is conclusive, then surely what the taxpayer did, or believed he was doing, is of no relevance whatever.

Furthermore, in view of the fact that the law was the most technical and complicated Revenue Act which had ever been written and that the country was at that time totally uneducated to Revenue Acts of this nature, the argument is an unsound one and particularly so in a test case involving the interests of a great many other taxpayers besides the respondents. The act of a taxpayer in endeavoring to comply with the Regulations of the Treasury

Department, under risk of heavy fines and penalties for disobedience, should not be used as evidence against him —certainly it is no evidence against all other taxpayers who did not act similarly.

9. The opinion reverses a rule of statutory construction long established and recognized in this Court.

The opinion states that the term "undivided profits" means "current undistributed earnings" and "that this is the meaning in which it was used by Congress is confirmed by the use of the expression 'earnings and profits' later in the same paragraph." We confess ourselves at a loss to follow this reasoning. That a change of words indicates a change of meaning, is, we submit, a well-recognized rule of construction. The argument here, is, however, that the change of words proves a continuation of the same meaning—or that the earlier words conveyed the same meaning as the later. Have we here a new rule of statutory construction violative of the long established rules of this Court? If so, are we to presume the obvious converse of the rule—that the repetition of a word indicates a *change* in meaning? We doubt that such a revolutionary principle would be deliberately adopted as the law of this Court.

Is not the true import of the change in phraseology in question as stated by the Court below? We believe it will bear repetition here:

> "An examination of Section 31 (a) and 31 (b) at once discloses that the Congress used the words 'earnings or profits' six times, whereas when referring to the rates applicable to the distributee it used entirely different phraseology, *i. e.*, 'most recently accumulated undivided profits or surplus' and 'for the years in which such profits or surplus were accumulated.'

> "It cannot be assumed that these words were used carelessly nor can the statute be approached with the presumption that the Congress intended that this phraseology should be equivalent to that which would express current earnings or profits. The time-worn observation may be indulged in that, if the Congress had intended to say 'earnings or profits' as referring to current earnings, it could readily have done so by using these words so long familiar in taxing statutes."

There was a reason for this change in phraseology which gives significance to the proviso in which they accrue (see *ante*, Points V, VI, pp. 12-15). If this changed phrase "earnings or profits" conveys no different meaning then it is redundant.

10. The Court also overlooks the fact that if by Section 31 (b) dividends are conclusively allocated first to current earnings, Section 10 (b) of the 1917 Tax Act would practically be unworkable.

The opinion refers to Section 10 (b) of the 1917 Act as supporting its construction of 31 (b) (see Opinion, footnote 9). An examination of 10 (b) will show that it does not support the prevailing opinion. Section 10 (b) does not refer to current earnings at all, nor distribution of such current earnings during the year of their acquisition. On the contrary, it requires the distribution of "the total net income of every corporation" "remaining undistributed six months *after the end of each calendar or fiscal year.*" That part of the "total net income of every corporation" which remains undistributed *"after the end of each calendar or fiscal year"* is not current undistributed earnings but prior surplus.

Section 10 (b) therefore lays down a rule requiring the distribution of prior surplus after the close of "each cal-

endar or fiscal year" and not during the year. It therefore lays down a rule diametrically opposed and inconsistent with the construction of 31 (b) adopted by this Court. Any attempt by the directors to carry out the provisions of 10 (b) would be not only embarrassed but frustrated by the construction of 31 (b) adopted by this Court. For the reason that no matter how the directors struggled by act or resolution to declare out prior surplus, all dividends declared would be automatically allocated by 31 (b) to the current earnings. The reference therefore to 10 (b) in the opinion, note 9, plainly misunderstands its relation to 31 (b). If there be any relation it supports and enforces the construction of 31 (b) adopted by the Court below and contended for by the respondents.

Again this Section 10 (b) furnishes another example also of the difficulties arising from the interpretation of the word "deemed" for which the Government contends. An illustration may be helpful.

A company has net 1917 income of $15,000,000, of which in 1917 it distributes $10,000,000, leaving $5,000,000 undistributed, which, as it develops later, is not necessary for "the reasonable requirements of the business." The exact figures probably would not be known until March, 1918. Section 10 (b) requires this $5,000,000 to be distributed by June 30, 1918, under penalty of a 10% additional tax. The company estimates on June 30, 1918, that it has earned a net income of $5,000,000 since January 1, 1918, and that it is now safe to distribute the above $5,000,000 balance of 1917 income. Therefore the directors solemnly pass resolutions, referring to Section 10 (b) distributing this $5,000,000 balance of the 1917 income to the shareholders. However, while they believe that they have complied with Section 10 (b), along comes the Government, and, if Section 31 (b) means what the opinion of this Court says it means, successfully maintains the proposi-

tion that the Company owes it $500,000 additional tax under Section 10 (b); because by Section 31 (b) it is *conclusively presumed* that the dividend in question was paid *out of 1918 earnings.*

It is no answer to this contention to assert that the directors on June 30, 1918 (or any subsequent year) could have complied with Section 10 (b) by first paying out the 1918 earnings to that date, and then the unneeded surplus of the prior year. This procedure would have been attended with all the uncertainty incident to estimating earnings up to an intermediate date. If such estimate erred, in excess, the directors would have unwittingly distributed capital. If the estimate was in defect, the corporation would have incurred without fault the penalty tax of 10 (b). This difficulty of reconciling the allocation rule of 31 (b) laid down in the opinion of this Court and the rule of 10 (b) is an argument not for, but against the construction adopted. Of course, if respondents' construction of 31 (b) which automatically allocated dividends to prior surplus is adopted, then all this inconsistency between that section and 10 (b) disappeared and the two rules are synchronized.

Only an entire misunderstanding of the rule laid down by 10 (b) and its relation to 31 (b) can account for the reference in the opinion.

11. The construction of the act adopted by this Court does not remove but emphasizes discrimination among holders of stock in different corporations.

The opinion points out that one of the Congressional objects was to avoid discrimination between stockholders of a corporation which had paid out its profits earned in years prior to 1916 and one that had not, by reason of "this rapid increase in income tax rate." There is no doubt that

this "unjust discrimination if no change were made in the then existing rule governing the taxation of dividends" motived Congress to pass Section 31 (b). It was to permit stockholders in these two classes of corporations to be placed upon a parity that permission was given to distribute surplus earned in prior years at the lower rates then prevailing. The Government construction of the Act, however, which this Court has adopted, gives this privilege to the corporations with one hand but takes it away with the other. While ostensibly permitting the corporations to declare out the earlier earnings at the lower rates, the construction of the law imputed to Congress in the opinion, fetters this privilege with an added condition—that all of the current profits should be first distributed—whether needed in the business or not. The effect of this would be that the corporation which had not declared out its earlier surplus could not place its stockholders on a parity with a corporation that had, without embarrassing itself by distributing all its current earnings and fastening on its stockholders the high surtaxes thereon. Surely had Congress had the intention to avoid "discrimination among the holders of stock in different corporations" of this sort, it would have carried that out by granting to all corporations the right during the year 1917 to declare out their prior surplus without condition or limitation. This would have simply and effectually removed any discrimination and this is exactly what the construction contended for by the respondents and adopted by the Court below does.

12. The aim of Congress to tax war profits has no bearing on the construction to be given to Section 31 (b); under either construction that aim was fully carried out.

It is stated in the opinion that "Congress had the special aim of making the war profits pay the higher war taxes." This is true but it does not support or bear upon the Government's construction of the Act adopted by the Court for the following reasons:

(1) Congress carried out this aim by levying the war profits and excess profits on the corporations' net income irrespective of whether they had distributed those profits or prior surplus. *It made no attempt to levy an additional war profits tax on the dividends received by the stockholders from those war profits.* Stockholders receiving dividends paid the high surtaxes solely on the amount of the stockholders' income and irrespective entirely of their source. Whether those dividends were paid by a conservative investment corporation receiving but a moderate rate of return on its capital invested or whether they flowed from a corporation making war profits was immaterial.

(2) What Congress intended by Section 31 (b) was that the earnings of corporations in the year 1917 and subsequent years, when distributed to the stockholders, should be subject to the higher surtaxes imposed by the 1917 Act. This purpose is accomplished equally by either construction of the Act in issue here. Under the construction contended for by the respondents, the earnings of the corporation in the year 1917 were evermore burdened with those taxes when distributed. They never could be declared out by the corporation without paying such taxes. The only question is, did Congress intend to remove the discrimination existing between the stockholders of cor-

porations which had prior to 1917 declared out their surplus and those which had not, by permitting declarations of dividends in the year 1917 to be charged to that prior surplus, or did Congress intend to indefinitely postpone the removal of that inequity until some date in the future when the corporation ceased to have current profits undistributed?

We submit that the intention of Congress was more fittingly carried out by the construction contended for by respondents.

13. The opinion precisely states respondents' contention; viz.: "its general aim was clearly to make the dividend, in whatever year paid, bear the tax rate of the year in which the profits of which it was a distribution had been earned; and for this purpose to treat as a unit the profits of the whole tax year."

This statement of the opinion is exactly respondents' contention. It is not, however, consistent with the construction of the Act adopted by the Court. By the Court's opinion "this purpose to treat *as a unit the profits of the whole tax year*" is defeated. As a matter of fact the profits of the year are split up into as many different segments as there are declarations of dividends and at each time there is a declaration the stockholders of the corporation are required to determine by an examination of the corporate accounts (whether those accounts are able to furnish the necessary data or not) the amount of the current earnings up to that point; and this determines whether or not the dividends are to bear the high tax rate of that year or not,—surely, this is not treating "as a unit the profits of the whole tax year," but the contrary.

14. Section 207 not only fails to support the Court's definition of "undivided profits" but contradicts it.

The opinion attempts to support its definition of "undivided profits" as "current undistributed income" by a reference to Section 207 of the Act. It says:

> "In §207 of the same Act, which deals with the War Excess Profits Tax on corporations and makes the tax dependent on the amount of the invested capital, the term 'undivided profits' is likewise used. That section, in paragraph (a) 3 defines invested capital as including 'paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits during the taxable year.'"

But the use of the words "undivided profits" in this section not only fails to support the Court's definition, but conclusively shows that "undivided profits" as used in the Act did not include "current earnings."

Section 207 (a) 3 defines invested capital as including

> "paid in or earned surplus and *undivided profits* used or employed in the business, exclusive of *undivided profits* earned during the taxable year."

If "undivided profits" means "current undistributed income" let us substitute the latter words in the above clause. It will then read:

> "paid in or earned surplus and *current undistributed* income used or employed in the business, exclusive of *current undistributed income* earned during the taxable year."

But "current undistributed income" must and can only be "*earned during the taxable year.*" "Current undistributed income" is identical with "current undistributed income earned during the taxable year" and if "undivided

profits" means "current undistributed income," it is likewise identical with "undivided profits earned during the taxable year." That which is excluded from invested capital is, therefore, identical with that which is included. We thus have Congress defining invested capital as including A+B+C—C.

It is thus clear that "undivided profits" cannot mean "current undistributed income" without imputing to Congress the above absurdity. It clearly means that account to which earnings have been transferred at the end of an accounting period. Section 207 (a) (3) thereupon becomes intelligible. At the end of the year undistributed profits, of course, includes the earnings of that year which have been so transferred. It was thus necessary in defining invested capital, which is determined over and not merely at the beginning of the year, to exclude from "undivided profits" that part which had been earned and transferred thereto at the end of the year.

III.

The above discussion we are confident will satisfy this Court that it was handicapped in understanding respondents' contentions by the lack of the oral argument and that a reargument should be granted to permit a full discussion of the issues involved on the part of respondents.

Respectfully submitted,

ARCHIBALD DOUGLAS et al.,
Executors of James Douglas,

By MATTHEW C. FLEMING,
ARCHIBALD DOUGLAS,
PAUL ARMITAGE,
EDWARD HOLLOWAY,
of New York City,
Attorneys for Respondents.

Certificate of Counsel.

We hereby certify that we are the counsel for the respondents here, that the foregoing petition for reargument is not interposed for delay, and that in our judgment the said petition is well founded.

MATTHEW C. FLEMING,
ARCHIBALD DOUGLAS,
PAUL ARMITAGE,
EDWARD HOLLOWAY,
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Attorneys for Respondents.

No. 524.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1924.

WILLIAM H. EDWARDS, Collector of Internal Revenue,

Petitioner,

against

ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of JAMES DOUGLAS, deceased,

Respondents.

BRIEF SUBMITTED BY LEAVE OF THE COURT

GEORGE WELWOOD MURRAY,
HARRISON TWEED,
Amici Curiae.

In the Supreme Court of the United States

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WILLIAM H. EDWARDS, Collector of Internal Revenue, *Petitioner,* *against* ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased, *Respondents.*	No. 524.

Brief Submitted by Leave of the Court by George Welwood Murray and Harrison Tweed, *Amici Curiae.*

Under the Revenue Act of 1913 all dividends were taxable at the rates applicable to the year in which they were received by the stockholder. The rule was the same under the Revenue Act of 1916, except that dividends which were paid out of earnings or profits accrued prior to March 1, 1913, were exempt from taxation. This exemption could be obtained by an express declaration of the corporation that the dividend was paid out of the surplus accumulated prior to March 1, 1913, even though there was surplus more recently accumulated. The right to so obtain the exemption after August 6, 1917, was taken away by an express provision in the Revenue Act of 1917, which required that the earnings and profits accrued since March 1, 1913, must first be distributed.

But what is important in this case is that by Section 31 (b) of the Revenue Act of 1917 Congress changed the rule that dividends were taxable at the rates applicable to the year in which they were *received by the stockholder*. The sole question is to determine what Congress intended that the new rule should be.

It is clear enough and is admitted by every one that in changing the rule for the taxation of dividends the purpose was to make taxable at the rates of prior years some of the dividends which already had been, and subsequently would be paid during 1917. Just why Congress wished to do this, we do not know. It may have been influenced by its conception of what was fair to stockholders, or it may have seen an advantage to the Government in *postponing* in certain cases the taxation of dividends at war rates. But this we *do* know, that Congress could not provide for a taxation of dividends different from the taxation of income from other sources unless the system was based upon some sound distinction and proceeded upon some reasonable theory.

That there is a difference between dividends and income from other sources is manifest. But on what theory can the difference be made the basis for a difference in taxation? One theory which would suggest itself would be that in a certain sense the earnings of a corporation constitute the income of the stockholder *when they are earned by the corporation*, because he has the immediate benefit of them in the enhanced value of his stock. But this theory, besides being almost certainly unconstitutional, would not have effected the purpose which Congress had in mind, for it would have instantly made taxable at 1917 rates all the earnings of a corporation during that year. Therefore, Congress could

not proceed upon that theory, although, as we shall see later, the Senate bill proceeded upon the modified theory that corporate earnings, *to the extent that they are presently or subsequently distributed*, constitute, retroactively if necessary, the income of the stockholder when earned by the corporation. This theory was rejected by the Conference Committee and Congress.

Another theory, which would constitute a sound basis for the differentiation in taxation, was that although dividends constitute income of the stockholder only when received by him, nevertheless they *represent the particular earnings of the corporation from which they were* IN FACT *paid*. This was a perfectly sound and logical theory. Dividends preserve their character of corporate earnings even into the hands of the stockholder. It was also peculiarly adapted to the problem presented. So far as possible, war taxes should be paid upon earnings made during the war period, and not upon earnings made prior thereto. In the case of dividends, this result cannot be obtained by taxing them at the rates applicable to the year in which they are received by the stockholder, but can be obtained by following them to their source and taxing them, when received, at the rate applicable to the year in which the fund from which they are paid was earned.

One difficulty with this theory as a system for the taxation of dividends was that, as is well known, dividends are for the most part paid out of a conglomerate fund which represents the earnings of several years. This difficulty could, however, be overcome by creating a presumption that a dividend is paid out of that part of the conglomerate fund most recently accumulated. There was also the difficulty that it had been recognized

that in declaring dividends a corporation had the right for tax purposes to ear-mark the dividends as paid out of the earnings of a particular year. This right might be exercised in such a way as to unfairly benefit the stockholders in certain corporations. A corporation which had accumulated a considerable surplus prior to January 1, 1917, would be able to pay dividends out of that surplus throughout the period of high rates of taxation, and later, when taxes were reduced, pay them out of the surplus then being accumulated, thus relieving its stockholders of any taxation at war rates. This could be prevented by creating the presumption that a dividend is paid out of the appropriate fund most recently accumulated.

When we turn and see what Congress said, we find its words perfectly adapted to make effective a system of the taxation of dividends based upon the theory that they should be taxed as income of the stockholder when received by him, but *at the rate applicable to the year in which the fund out of which they were* IN FACT *paid was earned*, subject only to the presumptions referred to. What Congress said was that dividend distributions "shall constitute a part of the annual income of the distributee for the year in which received" by him, but "shall be deemed to have been made out of the most recently accumulated undivided profits or surplus", and "shall be taxed at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation".

The taxpayer construes these words to refer to the fund technically and correctly known as "undivided profits or surplus", which is the fund from which dividends are in fact paid, and argues that the section provides for the taxation of dividends at the rates applicable

to the year in which the fund from which they are in fact paid was earned by the corporation, subject only to the proviso that they must be deemed to have been paid out of that fund, or the part of that conglomerate fund, most recently accumulated, notwithstanding any express declaration of the corporation to the contrary. The Government, on the other hand, construes the words "most recently accumulated undivided profits or surplus" to include current earnings, and claims that the section lays down an arbitrary rule for determining the rates of taxation, whereby a dividend is conclusively presumed to have been paid out of current earnings between the beginning of the tax year and the date of the payment of the dividend, to the extent that they are sufficient,—the amount of such current earnings to be subsequently ascertained as best may be and, if necessary, by arbitrary apportionment of the earnings for the whole of the year. We describe the rule contended for by the Government as arbitrary because, as every one knows, dividends are not in practice declared or paid out of current earnings. It is the purest fiction, contrary to every legal and accounting principle, to presume that dividends are paid from such an unreal source.

In considering the question of the payment of a dividend a board of directors rarely has before it any statement or information with respect to current earnings. It may be that in a general way the board knows whether the corporation is or is not earning money, but it has no accurate figures. Current earnings are really only prospective earnings, and they are regarded as such by a board of directors. Directors recognize that the fund from which a dividend is properly payable is

the accumulated surplus shown to exist at the close of the last accounting period. Current and prospective earnings or losses are of moment only in so far as the probable existence, or the roughly approximated amount thereof may affect existing surplus, and render a distribution of a part of that surplus advisable or inadvisable.

When a dividend has been declared by a board of directors, what happens is that the amount of the dividend is debited against accumulated surplus. Sometimes the amount of the dividend is set up as a credit to dividend account, when declared, and debited to that account, when paid. No attention whatever is paid to current earnings either at the time the dividend is declared or when it is paid. Dividends are not debited against current earnings, for the simple reason that there are no current earnings until their existence and amount is determined by a closing of the books at the end of an accounting period.

There can be no doubt that technically and correctly the words "most recently accumulated undivided profits or surplus" refer to earnings which have been determined to constitute "undivided profits or surplus" by the taking of inventories and the balancing of books, and have been "accumulated" by the expiration of an accounting period and their addition to surplus upon the books of the corporation, and that that is the fund from which dividends usually and normally are declared and paid. The question is whether this Court is to read those words in their correct and technical meaning, or whether it is to exercise its power of equitable interpretation to read them as including current earnings.

In approaching the question it is proper to bear in mind that while the answer depends upon the inten-

tion of Congress, that intention is to be found in the words of the statute. The question, says Hawkins in his "Treatise on the Principles of Legal Interpretation," is "not what the writer meant, but what he has authorized the interpreter to say it is probable was his meaning." More specifically Mr. Justice Holmes has said: "We do not inquire what the Legislature meant; we ask only what the statute means (12 Harv. L. Rev. 419). This principle finds its clearest application in a case in which technical words have been used in connection with a subject matter as to which they are appropriate. Under such circumstances there is little opportunity for a court of construction to find that the probable meaning of the legislature was other than that which the technical meaning of the words conveys.

The brief of the taxpayer points out many indications in addition to the words themselves creating the overwhelming probability that Congress did actually intend the result which will be attained by an interpretation of the words in their correct and technical meaning. We need not repeat them here.

Turning to the brief of the Government, we find definitions of "undivided profits and surplus" which are said to demonstrate that these words may have a meaning which includes "current earnings". (Government's brief, p. 37.) The utmost that those definitions accomplish is to create an ambiguity in the words used by Congress, and it may well be doubted whether they accomplish even that. Certainly, they do not resolve that ambiguity in favor of the interpretation for which the Government contends. That can only be done by evidence of circumstances sufficient to persuade this Court that Congress intended to use the words in the mean-

ing which those definitions are claimed to authorize. The ultimate inquiry, then, must be whether the circumstances to which the Government refers are sufficient to overcome the inherent probability that Congress used the words "most recently accumulated undivided profits or surplus" in their correct and technical meaning, and to compel the conclusion that they were used in what at most is their permissive sense. Those circumstances are:

(1) The circumstances attending the enactment of Section 31(b).

(2) The asserted circumstance that, as the Government claims, the construction of Section 31(b) urged by the taxpayer "leads to absurd results and produces inequalities and injustices among taxpayers".

(1) The circumstances attending the enactment of Section 31(b).

(a) The first circumstance relied upon by the Government in aid of its construction is that, as passed by the Senate, Section 31(b) *did* require that current earnings be taken into consideration in determining the fund from which dividends were to be deemed to have been paid. (Government's brief, p. 28.)

The Senate bill provided that dividends should be deemed to have been paid "from the net income of the years in which such distribution is made, or, if such income is insufficient, from the most recently accumulated undivided profits or surplus". The argument of the Government is, that the Conference Committee and Congress thought that the words "net income" were inappropriate or uncertain in meaning, and that they were

eliminated as "an improvement in draftsmanship, an expression of the same intention in more appropriate language".

Without stopping to refer to the obvious irony of this statement, we submit that it proceeds upon a complete misconception of what the Conference Committee and Congress did. The provisions of the Senate bill and the statute, as passed, respectively, provided that distributions to stockholders should be deemed to have been made:

Senate bill.	*Statute as passed.*
(1) "from the net income of the years in which such distribution is made or, if such income is insufficient,"	
(2) "from the most recently accumulated undivided profits or surplus,"	(1) "from the most recently accumulated undivided profits or surplus,"
(3) "and shall constitute a part of the annual income of the shareholder for the respective years in which earned by the corporation,"	(2) "and shall constitute a part of the annual income of the distributee for the year in which received,"
(4) "and shall be taxed to the shareholder at the rate prescribed by law for such year."	(3) "and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation."

It is obvious that the Conference Committee and Congress were concerned, not with the draftsmanship or phraseology of the bill, but with the principle upon which it was based. The Senate bill proceeded upon the theory that earnings of a corporation should, to the extent that they are presently or subsequently distributed, be treated as becoming the income of the stockholders *when earned by the corporation.* There was good reason why the Conference Committee and Congress should reject this theory, for, as the Government says in its brief, there would have been "endless confusion in determining how income received in 1917 could possibly constitute a part of the income of the distributee for a prior year, when he did not receive, and had no right to receive, the same." The theory was unsound legally, and unworkable practically.

The theory of the Conference Committee was that the earnings of a corporation do not constitute part of the income of a stockholder until he receives them in the form of dividends, and that when he does receive them they represent the earnings of the corporation for the year or years during which the fund from which they were paid was earned and accumulated by the corporation. Therefore, the stockholder should not pay war taxes upon his dividends unless they are paid from a fund which was earned and accumulated by the corporation during the period of taxation at war rates.

It is the purest imagination to say that when in making this radical change in principle the Conference Committee changed the words of the Senate bill, it is to be presumed that those changes in phraseology "were designed not to change the meaning expressed in the Senate bill, but to express that intention in clearer and

more precise language". The Conference Committee changed the phraseology not to improve the draftsmanship, but because, having changed the entire principle of the taxation of dividends, it was appropriate, if not, indeed, necessary, to change the rule of conclusive presumption laid down by the Senate bill. Since the theory of the Senate bill was that earnings of a corporation should be treated as income of the stockholder *when earned by the corporation*, it was appropriate that there should be laid down a presumption that dividends were paid out of current earnings. But when the Conference Committee changed the principle and declared that dividends should be treated as income of the stockholder when received, but should be taxed at the rates applicable to the year in which the fund out of which they were paid had been "accumulated by the corporation", it would have been most illogical and inappropriate to make any such presumption. All that was necessary or appropriate was a presumption that dividends should be presumed to have been paid out of the "undivided profits or surplus" which had been "most recently accumulated".

To say that Congress meant current earnings when it said "most recently accumulated undivided profits or surplus", is not only to pervert the meaning of the words it used but also to defeat the purpose which manifestly inspired the deliberate choice of those precise words.

Any suggestion that the elimination of the provision that dividends should be presumed to have been first paid out of current earnings, was made without an appreciation of the distinction between "current earnings" and "accumulated undivided profits and surplus", and that the act, as finally passed, laid down the same rule

as the Senate bill, must be predicated upon the assumption that the Conference Committee and Congress paid not the slightest attention to the problem to be dealt with or the words used, in disposing of it. It is not always that Congress gives intelligent consideration to a specific problem or to the use of words. When the record discloses that it *has* done so, it is hardly fair to construe the legislation as though it had not.

(b) The second circumstance relied upon by the Government is, that to give the words their technical meaning would result in taxing most of the dividends paid during 1917 at the rates applicable to past years. (Government's brief, p. 32.) But this circumstance is no evidence of a contrary intention. Why should it be assumed that Congress intended to prevent the taxation of dividends received during 1917 at rates applicable to prior years, when the whole purpose of the legislation was to change the rule that dividends were taxable at the rates applicable to the year in which they were received? It could not have intended that they should be taxed at the rates applicable to *later* years, and if it had intended that they should be taxed at 1917 rates it would have retained the old rule. It would seem that the persuasiveness of this circumstance is precisely the opposite.

(c) The third circumstance referred to by the Government is, that the construction suggested by the taxpayer would result in reducing tax revenue from dividends. (Government's brief, p. 53.) This is not the fact. The utmost effect of the section, even under the taxpayer's theory, would be to postpone, as to certain

dividends, the impact of war rates. Rates were then increasing, but when the tide should turn and rates should be *decreasing* from year to year, dividends then received would be taxable at the *higher* rates applicable to a past year. There would have been no exemption of dividends. There would simply have been a postponement of the collection of taxes upon dividends at war rates until the dividends received by the stockholder were paid out of war profits. If the adoption of the taxpayer's construction involves loss of revenue, it is not because of anything inherent in that construction, but is due to the fact that the provision was eliminated after it had worked a favorable disparity in the taxation of dividends and before it had begun to have a contrary effect.

(d) Another circumstance relied upon by the Government to show that Congress did not intend that the words of Section 31(b) should have their technical meaning is, that something over a year later a Congressman, who had been a member of the Conference Committee, in reporting to the House in connection with the Revenue Act of *1918*, stated that the language of Section 31(b) in the *1917* Act, included "current earnings". (Government's brief, p. 35.) The statement amounts to nothing. The opinion of a member of Congress as to the meaning of a proposed bill is to be considered if it appears that Congress adopted his construction. It is on this principle that the construction of a bill contained in a Committee report may be some evidence of what Congress intended, since it is to be presumed that the passage of the bill constitutes an adoption of that construction. But this principle has no application to the construction of past legislation.

(2) The asserted circumstance that, as the Government claims, the construction of Section 31(b) urged by the taxpayer "leads to absurd results and produces inequalities and injustices among taxpayers."

This, it may cynically be remarked, is true of every tax statute, no matter how construed. We think that an examination of the Government's argument will reveal that Section 31(b), as construed by the taxpayer, is a comparatively mild offender, if indeed it offends at all.

(a) The first of the defects referred to by the Government is that under the taxpayer's construction of Section 31(b) an inconsistency might arise between the purview of the section and the proviso. (Government's brief, p. 44.) The case put by the Government is that of a corporation which has distributed all of the undivided profits and surplus accumulated between March 1, 1913, and December 31, 1916, but has on hand a surplus accumulated prior to March 1, 1913, and has been earning money during the year 1917. The Government argues that if a further dividend should be paid, it would not, under the taxpayer's construction, be taxable at the rates applicable to prior years, and yet it would not be exempt from taxation because the proviso grants exemption only after the "earnings and profits accrued" since March 1, 1913, have been distributed, and those words include current earnings of the year 1917.

There are so many fallacies in this argument of the Government that we shall not discuss them all. The Government first assumes a construction of the proviso which may or may not be correct, and then assumes that if there is an inconsistency between it and the purview,

as construed by the taxpayer, the taxpayer's construction of the purview could not have been contemplated by Congress. We do not need to determine the correctness of the Government's assumption that the words "earnings and profits accrued" since March 1, 1913, include current earnings of the year 1917. If those words do *not* include current earnings for the year 1917, then there is no inconsistency between the purview and the proviso. If, on the other hand, they *do* include current earnings, that is no reason why it is to be inferred that Congress intended that the words "most recently accumulated undivided profits or surplus" should also include current earnings. The question of the rate at which dividends should be taxed, and the question whether they should be exempted because paid from what was capital at the time of the constitutional amendment, are distinct questions and may properly be governed by different rules.

This is a complete answer to the Government's argument. We cannot, however, refrain from going further and pointing out that if the Government's construction of the proviso is *right*, the insertion of the proviso is a circumstance strongly tending to show that the Government's construction of the purview is *wrong*. If the purview requires the inclusion of current earnings, why was the proviso added? It would be pure surplusage. In the Senate bill, which *did* include current earnings, there was no proviso. Assuming that the words "earnings and profits accrued" since March 1, 1913, do include current earnings, the fact that the Conference Committee added the proviso when it changed the Senate bill would seem to indicate that it saw the necessity for the addition of a proviso if current earnings were to be *included* for purposes of determining the *exemption* of

dividends. It could have seen such a necessity only if it appreciated that by the use of the words "most recently accumulated undivided profits or surplus" current earnings were *not included*.

(b) The Government also attempts to establish an inconsistency between the meaning of the words "undivided profits or surplus" as construed by the taxpayer in Section 31 (b) and as used in Section 207 (a). (Government's brief, p. 42.) Section 207(a) says that in determining the invested capital of a corporation there shall be included the value of cash and tangible property paid in and "paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year". The Government assumes that the express exclusion of undivided profits earned during the taxable year shows that Congress understood the words "undivided profits or surplus" to include current earnings. There is no warrant for this assumption. In Section 207 it was necessary to exclude undivided profits earned during the year, not because the words "undivided profits or surplus" include current earnings, but because during the taxable year current earnings might be converted into undivided profits. Having said that undivided profits should be included in invested capital, it was obviously necessary to exclude the undivided profits coming into existence at the end of the taxable year. If Congress had said "exclusive of current earnings" then it might have been argued that in the opinion of Congress the words "undivided profits or surplus" include current earnings. But Congress did not say that. And the fact that it did not say it proves that in its opinion current earnings were not included within the meaning of

the words "undivided profits or surplus". The phraseology of Section 207 hurts rather than helps the Government.

(c) In an effort to create an "absurdity, inequality or injustice," the Government puts the case of four corporations, each having the same earnings for 1917 but having different accounting periods, one accounting monthly, one quarterly, one semi-annually, and one annually. (Government's brief, p. 50.) It argues that under the construction of the taxpayer the stockholders in each of these corporations would be taxed at different rates. Apparently it admits, however, that the only result would be the *relative postponement* of the taxation of the stockholders in such corporations. All of them would eventually pay taxes at war rates upon the war earnings. Furthermore, the result of the different methods of bookkeeping would not directly or arbitrarily affect the rates of taxation, but would simply bring about the result that under one method the stockholders would, in fact, receive dividends paid out of war earnings sooner than if one of the other methods had been followed. We need to go no further for a similar situation than the well recognized distinction between corporations or individuals which keep their accounts upon an accrual basis and those which keep them upon a cash basis of receipt and disbursement. Finally, in the case put by the Government even this disparity in the taxation of the stockholders of the various corporations disappears if there is applied the deep-rooted principle that for tax purposes an annual accounting is required.

(d) Finally the Government puts the case of a corporation organized in 1917 or one which had no surplus on December 31, 1916. (Government's brief, p. 52.) It

asks the question: At what rates would dividends declared and paid in 1917 be taxed? The answer is at 1917 rates, for the simple reason that Section 31(b) quite properly does not make them taxable at any other rate. Therefore, since they constitute income within the general definition of the statute, they must be taxed at 1917 rates. The Government argues that to say this is to admit that the words "undivided profits or surplus" may include current earnings. But the truth is that the dividends are taxed at 1917 rates because they are *not* included in the provision which provides for taxation at different rates.

Conclusion.

These are all of the circumstances to which the Government refers in support of its argument that collateral circumstances require that the words which Congress used be read to convey a meaning other than that which they correctly and technically convey. We think that a fair consideration of them reveals that they fall far short of having this effect and that they do not justify the judicial construction which the Government seeks.

In conclusion, two questions may be asked:

(1) If it was the intention of Congress to include current earnings, why did it not say so?

(2) If it was the intention of Congress *not* to include current earnings, how could it more accurately and precisely have expressed that intention than in the words which it used?

Taxpayers readily appreciate the great responsibility imposed upon the Treasury Department and recognize

that it must give itself the benefit of every conceivable doubt in the construction of tax statutes. But it seems to have gone a little far in the present instance. The nature of the arguments upon which it relies suggests that they are afterthought and farfetched justifications for a course of action determined upon solely in the interests of collecting revenue. When all is said and done, it cannot be gainsaid that Congress used apt and appropriate, definite and unambiguous words, to lay down a perfectly fair and logical and practical system for the taxation of dividends. It seems a little unnecessary that because a different system would have produced more revenue, an attempt should be made to torture the well-chosen words of Congress into a meaning which would sustain that system. That Congress does not always clearly express its intention must be admitted. But that is all the more reason why respect should be shown for its intention when expressed in legislation based upon a sound theory, fair and practical in operation, and stated in precise terms.

Respectfully submitted,

George Welwood Murray.
Harrison Tweed,
Amici Curiae.

Office Supreme Court U.S.
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No. 524.

In the Supreme Court of the United States,

OCTOBER TERM, 1921.

WILLIAM H. EDWARDS, Collector of Internal Revenue,
Petitioner,

against

ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased,

Respondents.

On Writ of Certiorari to the Circuit Court of Appeals for the Second Circuit.

BRIEF OF GEORGE E. HOLMES, RANDOLPH E. PAUL AND DONALD HAVENS, AS AMICI CURIAE.

GEORGE E. HOLMES,
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IN THE

Supreme Court of the United States,

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WILLIAM H. EDWARDS, Collector of Internal Revenue, Petitioner, against ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased, Respondents.	No. 524.

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BRIEF OF GEORGE E. HOLMES, RANDOLPH E. PAUL AND DONALD HAVENS, AS AMICI CURIAE.

Statement.

The question presented to this Court by the writ of certiorari granted in this case is the true construction of Section 31 (b) of the Revenue Act of

1917; and, more particularly, whether under that section dividends paid by a corporation to its shareholders in the year 1917 are taxable to the shareholders at the rates prescribed by law for the year 1917 to the extent of the amount of corporate earnings of that year on hand at the time of declaration or payment, or whether such distributions are by the terms of Section 31 (b) allocated to the surplus or undivided profits accumulated in years prior to 1917 and are, therefore, taxable at the rates prescribed for such prior years.

Argument.

It is a well settled rule of statutory construction that where the language of a statute is ambiguous and its meaning doubtful, the Court will look to the history of the times and of the law, the condition of the law at a particular time, the mischief or evil sought to be remedied, and other kindred things which would put it in the light that the lawmakers enjoyed and enable it to view the situation which appeared to those who passed the act.

U. S. vs. Standard Oil Co., 221 U. S., 1.

The enactment of Section 31(b) of the Revenue Act of 1917 was brought about by the extraordinary circumstances existing at the time that revenue measure was pending in Congress. The entrance of the United States into the Great War created an astounding need for revenue. Congress turned to the income tax, then a comparatively new in-

strument of taxation, to collect the main portion of this revenue. *Inter alia* it increased the surtaxes on individuals from rates which in 1916 had gradually ascended to a maximum of 13% to rates which sharply ascended to a maximum of 63%.

During the consideration of the Bill by Congress, a protest arose against the application of the new proposed rates to income in the form of dividends from corporations. It was represented to Congress that if the economic wisdom of imposing the higher surtax rates rested on the fact that through inflation and the paramount needs of the allied nations for war material abnormally high incomes would be earned in 1917, of which the Government was justified in taking an extraordinarily large share, dividends earned in the prewar years should not bear the heavy impost merely by reason of the fact that they were not distributed until 1917. In short, it was urged that a great inequality between taxpayers would be caused, for example, by taxing dividends at 11% if by chance they were distributed at the end of, but within, 1916, and at 60% if they were distributed a short time after the beginning of 1917, although in fact such dividends were from earnings of the same prewar year. Force was added to this argument by the fact that it is quite generally the custom to defer the payment of dividends until after the corporate books are closed at the end of the year, and the physical work of such closing may require many weeks of time. As a result, the earnings of a corporation in one year are not usually distributed in dividends to stockholders until the following year or later. Dividends received in 1917, therefore, it was argued, would not,

in most cases at least, be distributions of 1917 corporate income but income of earlier years and as such, should not be subjected to the high war rates of tax.

The fact that the Revenue Act of 1917 was not passed until October 3, 1917, and was retroactive to January 1, thus taxing many distributions made without knowledge of the high rates was also presented as an argument for special treatment of dividends.

In the Revenue Act of 1917, Congress did in fact provide against the taxation at 1917 rates of dividends from earnings of 1916 and years prior thereto. The doubt in the construction of the statute that gives rise to the present case, concerns itself with the precise method to be followed in determining from the earnings of which year dividends are paid, and particularly with the following question:

Are dividends paid in 1917 deemed to be out of 1917 earnings to the extent of such earnings on hand at the time of declaration or payment (and, therefore, taxable at 1917 rates), or are they deemed to be out of undivided profits or surplus accumulated in prior years (and, therefore, taxable at the rates of those years)?

Respondent in this case claims that Congress intended that dividends paid in 1917 should be deemed to be out of surplus or undivided profits accumulated in prior years (and therefore taxable at the rates of those years) whether or not there were 1917 earnings on hand at the time of declaration or payment.

The Bureau of Internal Revenue, on the other hand, has taken the position in this case and in its

rulings that Congress intended that if the paying corporation had on hand any profits earned in 1917 at the time a dividend was paid, then such dividend should be deemed to be out of such earnings to the extent thereof (and, therefore, taxable at 1917 rates).

The language of Sec. 31 (b) of the Revenue Act of 1917, which has caused these divergent interpretations, reads as follows (italics ours):

> "Any distribution made to the shareholders or members of a corporation, * * * in the year nineteen hundred and seventeen, or subsequent tax years, shall be *deemed* to have been made from the *most recently accumulated undivided profits or surplus*, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, * * * but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen profits accrued prior to March first, nineteen hundred and thirteen."

The petitioner contends that the words *"most recently accumulated undivided profits"* should be construed to mean the accumulated earnings of 1917 up to the date of payment of the dividend, arrived at if necessary by the expedient of prorating or apportioning. The respondent contends, on the other hand, that the *"most recently accumulated undivided profits or surplus"* should be construed to mean the undivided profits or surplus found to exist upon the balancing of accounts and closing of the books at the end of the preceding fiscal year.

The rule of construction has been laid down by this Court that the formal reports of the Committees having in charge a pending legislative bill, including the bill as introduced and changes made in the frame of the bill in the course of its passage may be referred to as bearing upon questions of legislative intent.

> *U. S. vs. St. Paul M. & M. R. Co.,* 247 U. S., 310, 314.

The meaning Congress intended by the use of these words is, we believe, clearly indicated by the changes in the language of the bill in the several stages of its passage through the House, the Senate and the Conference Committee.

The bill as introduced in, and passed by, the House, contained no provision governing the allocation of dividends, for the purpose of determining the surtax rate applicable, to the earnings and profits, or surplus, of previous years. The following chart will illustrate graphically the various changes made in the pertinent section (31) of the bill during its consideration by Congress:

1st Draft

When reported to the Senate by the Finance Committee on July 3, 1917, the Bill contained the following provision (italics ours):

"Provided, further, That dividends declared and paid in the year nineteen hundred and seventeen or subsequent tax years shall be deemed to have been paid

from the net income of the years in which paid

or from the most recently accumulated surplus,

and shall be part of the annual income of the shareholder for the respective years *in which earned* by the Company, and shall be taxed to the shareholder at the rate prescribed by law for such years."

2nd Draft

The Bill was recommitted to the Senate Finance Committee and on August 6, 1917, was again reported with amendments. The amendment, as reported on that day and as passed by the Senate on September 10, 1917, read (capitalizing ours):

"Provided, further, That any distribution made to the shareholders of a corporation, joint stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made

from THE NET INCOME OF THE YEARS IN WHICH SUCH DISTRIBUTION IS MADE, OR, IF SUCH INCOME IS INSUFFICIENT,

from the most recently accumulated undivided profits or surplus,

and shall constitute a part of the annual income of the shareholder for the respective years in which earned by the corporation, joint stock company, or association, or insurance company, and shall be taxed to the shareholder at the rate prescribed by law for such year."

3rd Draft

The Bill was then sent to Conference. As agreed to in Conference and enacted into law Section 31 (b) read as follows (italics ours):

"Sec. 31 (b). Any distribution made to the shareholders or members of a corporation, joint stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, *shall be deemed to have been made*

from the most recently accumulated undivided profits or surplus,

and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association or insurance company,

but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen."

The significant change in the Bill as enacted after conference, as compared with the Bill as passed by the Senate before conference, was the elimination of the words *"the net income of the years in which such distribution is made, or if such income is insufficient."*

The petitioner's contention that Section 31 (b), as enacted, requires that dividends paid in 1917 shall be deemed to be out of 1917 current earnings if any existed at the time the dividend was paid would be sound if either the first or the second draft of the provision above set forth had been enacted into law. The language that was enacted, however, plainly indicates a change in meaning and intention.

The meaning of Section 31 (b), as originally passed by the Senate, is perfectly clear. Thereunder distributions were to be deemed to be made out of (1) "the net income of the year in which such distribution is made," or if that income was insufficient, then (2) "from the most recently accumulated undivided profits or surplus." This language has no ambiguity; it establishes beyond argument a definite order of distribution. Net income during the year 1917 up to the time of any dividend would be deemed to be distributed by such dividend. After the exhaustion of such net income any further distribution would be deemed to be from "the most recently accumulated *undivided profits or surplus.*" This language in the Senate Bill expresses clearly and precisely the meaning which the petitioner contends is conveyed by the law as enacted.

The second source of distribution specified in the Senate draft, however, is the *only* source specified in the law as enacted. The provision that distributions would be deemed to be out of "the net income of the year in which such distribution is made," source (1) above, was eliminated.

It is the contention of the petitioner that this elimination is without effect and that the meaning of the statute is the same as its meaning would have been had the elimination not been made; that the language left in the Bill means the same as that language preceded by the clause deleted. It is to be noted, however, that the deleted clause was used in contradistinction to the phrase "undivided profits or surplus." It would seem to follow, therefore, that the deletion signified a legislative intent to depart from the meaning expressed unambiguously in the Senate draft. If the elimination means anything it must mean that Congress intended that the net income of the year of distribution should *not* be deemed to be a source of distribution.

The petitioner's theory presupposes that the deleted clause was mere surplusage and was eliminated for this reason. If the avoidance of surplusage had been the object, the natural and obvious method of accomplishment would have been to substitute the phrase "earnings or profits" for the deleted clause. All ambiguity could have been avoided and the statute made shorter by amending it to read "any distribution made to the shareholders * * * of a corporation * * * shall be deemed to have been made from the most recently accrued *earnings* or profits * * *." Congress had this phrase ready at hand. It was the phrase used in

the 1916 Act and in Section 31 itself it is used no less than six times. Instead of continuing its use, however, Congress used a different phrase. Only one presumption can follow—an intent to convey a different meaning. As expressed by the Circuit Court of Appeals in its opinion below:

> "An examination of sections 31 (a) and 31 (b) at once discloses that the Congress used the words 'earnings or profits' six times, whereas when referring to the rates applicable to the distributee it used entirely different phraseology, *i. e.*, 'most recently accumulated undivided profits or surplus' and 'for the years in which such profits or surplus were accumulated.'
>
> It cannot be assumed that these words were used carelessly nor can the statute be approached with the presumption that the Congress intended that this phraseology should be equivalent to that which would express current earnings or profits. The time-worn observation may be indulged in that, if the Congress had intended to say 'earnings or profits' as referring to current earnings, it could readily have done so by using these words so long familiar in taxing statutes."

Nor can it be urged that the deleted clause was abandoned because the phrase "net income" had a technical statutory meaning which would not properly apply to the sources of dividend distributions. The fact that the phrase may have imperfectly

carried out the intent of the Senate does not obviate the fact that it had an intention (before conference) to resort to current earnings as the source of corporate distributions made in 1917; no other meaning can be given to the language eliminated from the Bill, and after the elimination Congress deliberately refrained from substituting the phrase "earnings or profits" which would perfectly have carried out the intention of the Senate, and the meaning now contended for by the petitioner.

A situation strikingly similar to the instant case came before this court in *Lapina vs. Williams*, 232 U. S., 78. The exclusion clauses of the Immigration Acts prior to those passed in 1903 and 1907 had used the words "alien immigrant" and had been held not applicable to aliens domiciled in the United States (therefore not "immigrants") returning thereto after temporary absence. The statute passed in 1903, as it came from the Senate, contained the same words but in conference the word "immigrant" was eliminated so that the statute as finally passed and also the Act of 1907, used the word "alien" alone. The Court, after reviewing this legislative history, held that the new act of 1907 was applicable even to aliens domiciled in the United States returning thereto after a temporary absence abroad. The Court, after quoting at length from the Committee's reports on the 1903 Act, said at pages 90 and 91:

> "The Senate inserted the word 'immigrant' in one place but it was eliminated in conference. * * * whatever considerations may have combined to bring about the judicial in-

> terpretation of the acts that preceded the Revision of 1913, the committee reports already cited sufficiently show that the language of the new act was chosen not for the purpose of adopting, but in order to avoid, that interpretation."

Is it not equally clear in this case that the Committee reports and the history of the bill above set forth sufficiently show that the language of the act as approved was chosen not for the purpose of adopting, but in order to avoid, the meaning conveyed by the words contained in the Senate bill and eliminated by the Conference Committee?

The petitioner contends that the terms of the proviso to Section 31 (b) show that the words "undivided profits or surplus" mean the same as the words "earnings or profits" and include current earnings. This proviso reads:

> "• • • Nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made."

To enforce its point the petitioner uses the illustration of a corporation having a March 1, 1913, surplus and 1917 current earnings but no surplus accumulated in 1914, 1915 or 1916. Under the above proviso, it cannot distribute its March

1, 1913, surplus until all "earnings or profits" since accrued have been distributed. The phrase "earnings or profits" admittedly includes 1917 current earnings. And yet, the petitioner argues, if a dividend is paid in 1917, under the respondent's theory, this will be deemed to be out of March 1, 1913 (the most recently accumulated) surplus. Under the terms of the proviso, however, this surplus cannot be distributed until the 1917 earnings have been distributed. This alleged dilemma is proposed in opposition to the respondent's construction of the section.

The dilemma, however, we believe, does not exist. Section 31 (b) lays down a rule of presumption as to the source of corporate distributions. The proviso excepts from this rule March 1, 1913, surplus. *The presumption need and can be indulged in only if more than one source of distribution exists.* In the illustration suggested by the petitioner, there is only one possible source of distribution, to wit: 1917 earnings. The March 1, 1913, surplus cannot be considered because of the proviso. There are no undivided profits or surplus accumulated since that date. The only source left is 1917 earnings. With a single source to be considered, no presumption as to source need be indulged in and the rule of presumption laid down by the body of the section has no application. The intent of Congress as to the allocation of corporate distributions is, we believe, clear. They are to come first out of 1916 surplus, then 1915, 1914 and December 31, 1913, surplus in the order named. All surplus except tax-free March 1, 1913, surplus having then been exhausted, the next source of

distribution is 1917 earnings. After all taxable distributions have thus been made, the tax-free March 1, 1913, surplus may be distributed.

That the respondents' theory is the correct theory of construction is clear from the very existence in the section of the proviso relied on by the petitioner. If the petitioner's construction were correct, the proviso would be mere surplusage. If current earnings were required to be first distributed and thereafter the surplus of prior years down to March 1, 1913, all earnings or profits accrued since that date would obviously be distributed before that surplus would be reached. The proviso, therefore, that all earnings or profits accrued since March 1, 1913, must be first distributed before March 1, 1913, surplus would be entirely redundant. The Senate Bill which provided this method of distribution contended for by the petitioner, did not contain the proviso. It was only when the Bill was amended in conference that the proviso was added. Its addition shows a clear realization by the Conference Committee of the meaning and effect of the elimination of the clause deleted from the Bill. Under the Senate Bill tax-free distributions could not be made until all taxable distributions had been made. The elimination of the deleted clause, however, would have permitted (but for the addition of the proviso) the distribution of March 1, 1913, surplus before 1917 earnings. To prevent this possibility the proviso was added. The order of distribution thus became in the law as enacted, first 1916 surplus and then in the order named, 1915, 1914 and December 31, 1913 surplus, 1917 earnings and finally March 1, 1913, surplus.

CONCLUSION.

Under the provisions of Section 31 (b) of the Revenue Act of 1917, dividends paid in 1917 are deemed to be paid out of undivided profits or surplus most recently accumulated in prior years, whether or not the distributing corporation had on hand at the time of distribution 1917 current earnings, and such dividends are taxable at the rate of the year in which the undivided profits or surplus from which the dividends are paid was accumulated.

Respectfully submitted,

GEORGE E. HOLMES,
RANDOLPH E. PAUL,
DONALD HAVENS,
Amici Curiae.

Office Supreme Court
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No. 129

IN THE

Supreme Court of the United States

OCTOBER TERM, 1924.

WILLIAM H. EDWARDS, Collector of Internal Revenue,
Petitioner,

against

ARCHIBALD DOUGLAS, GEORGE NOTMAN and EDMUND COFFIN, as Executors of the Estate of James Douglas, deceased,
Respondents.

ON WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

SUPPLEMENTAL BRIEF OF GEORGE WELWOOD MURRAY, GEORGE E. HOLMES, HARRISON TWEED, RANDOLPH E. PAUL AND DONALD HAVENS, AS AMICI CURIAE, FILED BY PERMISSION OF THE COURT.

GEORGE WELWOOD MURRAY,
GEORGE E. HOLMES,
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Pandick Press, Inc., 22 Thames St., New York, U. S. A.

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In the course of oral argument of this appeal on the two opposing points of construction of Section 31 (b) of the Revenue Act of 1917, the possibility of a third construction of the language of that provision was suggested, *i. e.*, that in interpreting the statutory requirement that distributions "shall be deemed to have been made from the

most recently accumulated undivided profits or surplus" the surplus at the end of the year in which the dividends were paid must be taken into account. The basis of this suggestion was that in applying the words "most recently" to an actual case, we must look at it from the standpoint of the stockholder preparing his return on March 15th of the year following the year of distribution, and that as to him at that time the surplus accumulated at the end of that year was "the most recently accumulated."

We believe that this suggestion contains, *inter alia*, three fundamental errors:

(1) It substitutes a strained for a reasonable construction of the clause.

(2) It assumes that all taxpayers receiving dividends are not required to make their returns until after the close of the distributing corporation's fiscal year.

(3) It is inconsistent with other sections of the Act.

Section 31 (b) provides that any distribution made to stockholders "shall be deemed to have been made from the most recently accumulated undivided profits and surplus." The reasonable and natural assumption is that when any distribution is made from a fund, that fund is already in existence at the time of the distribution from it. To presume that distributions made during 1917 were made from the "undivided profits and surplus" existing on December 31, 1917, is to admit of distributions from funds non-existent at the date of the distribution. The suggested construction requires the extraordinary assumption that Congress intended to treat a dividend paid, for instance, on February first, as having its source in profits made during the ensuing eleven months up to December thirty-first. To

create such an artificial presumption, so contrary to the fact, it would be necessary to state such presumption in clear and unambiguous language. On the contrary, such a construction strains the meaning of the plain language of the Act, for it is to be assumed that when Congress speaks of distribution from a fund, it presumes the fund in existence at the date of the distribution.

It was suggested that we must look at the phrase "most recently accumulated undivided profits and surplus" from the standpoint of a stockholder who makes his return on March 15, 1918, and to whom at that time the surplus of the corporation on December 31, 1917, would be the "most recently accumulated undivided profits and surplus." This point of view would hardly be the point of view of the average taxpayer who would find it difficult to conceive of payments out of non-existent funds; it could never be the point of view of a taxpayer receiving dividends from a corporation whose fiscal year does not end until after March 15th. For example, a corporation whose fiscal year ends on June 30th pays a dividend on October 31st. How can a stockholder receiving this dividend and preparing his return on March 15th deem this to have been paid out of the surplus which will not be determined until three months later? The same difficulties would exist in the case of corporation stockholders whose fiscal year was different from the taxable year of the distributing corporation.

Upon page 56 of respondent's main brief, it is pointed out that the Government's construction of Section 31(b) would render it irreconcilable with Section 10(b). The point applies with even greater force to the now suggested construction of Section 31(b) for under such construction directors of a corporation in order to avoid the penalty of

Section 10(b) would be required not only to estimate accurately their earnings for the first six months of any year, but would also be required to estimate accurately at the end of the first six months the prospective earnings for the last six months of the year, with the alternatives: (1) if their estimate of these earnings was too low they would be violating Section 10(b); and (2) if too high, they would be impairing the capital of the corporation.

The following conclusions may fairly be drawn:

(1) The natural meaning of the phrase under discussion is that contended for by the respondents.

(2) The construction suggested requires a strained construction of the language of this section.

(3) The reason offered in support of the suggested construction is based upon the mistaken assumption that stockholders are never required to make their returns until after the close of the fiscal year of the distributing corporation.

(4) The construction contended for by respondents harmonizes with the rest of the Act; the construction suggested is irreconcilable with Section 10(b) of the Act.

Respectfully submitted,

GEORGE WELWOOD MURRAY,
GEORGE E. HOLMES,
HARRISON TWEED,
RANDOLPH E. PAUL,
DONALD HAVENS,
Amici Curiae.

(15)

SUPREME COURT OF THE UNITED STATES.

No. 129.—October Term, 1925.

William H. Edwards, Collector, etc., Petitioner, *vs.* Archibald Douglas et al., Executors of James Douglas.	On Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

[November 23, 1925.]

Mr. Justice Brandeis delivered the opinion of the Court.

Section 31(b), added by § 1211 of the Revenue Act of 1917, c. 63, Title XII, 40 Stat. 300, 338 to the Revenue Act of 1916, provides: "Any distribution made to the shareholders . . . of a corporation . . . in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, . . . but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen. . . ."

James Douglas received from Phelps Dodge Corporation in September and December, 1917, two dividends, called at the time "depletion dividends," aggregating $328,400. He, and later his estate, claimed that these dividends were not taxable because they were a return of capital, not income. The Commissioner of Internal Revenue insisted that they were taxable and assessed the tax at the 1917 rate. It amounted to $173,579.72. The estate paid the tax under protest, and brought, in the federal court for southern New York, this suit against the Collector to recover the full amount so paid. The contention was repeated that the dividends were not taxable because not constituting income. In addition, it was claimed that, if they were taxable at all, it was not at the 1917 rate, but at the rate for 1916. The income tax rate imposed upon

individuals for the calendar year 1917 by the 1917 Revenue Act was much higher than that imposed for the year 1916 by the Act of September 8, 1916, c. 463, Part I, 39 Stat. 756. The District Court concluded that the dividends were income and that they were taxable at the 1917 rate. It entered judgment for the Collector. 287 Fed. 919.

This judgment was reversed by the Circuit Court of Appeals. It agreed with the District Court that the dividends were not a distribution of capital. But it found that there was on hand on December 31, 1916, in the surplus account, a balance of profits earned in that year amply sufficient to enable the corporation to pay these dividends out of such surplus; held that by reason thereof the dividends received by Douglas should have been taxed under § 31 (b) at the 1916 rate; and ordered that a mandate issue directing the District Court, upon a new trial, to enter judgment for the Douglas estate in accordance with its conclusions. 298 Fed. 229. This Court granted a writ of certiorari. 266 U. S. 596. The assertion of the estate that the dividends were a distribution of capital was not renewed in this Court; and the character assigned to the dividends by the corporation was treated here as of no legal significance. The sole question requiring decision[1] is whether these dividends paid in 1917 shall be deemed to have been paid out of the earnings of that year or out of an accumulated surplus built up in 1916 and earlier years. The question does not concern the corporation. The stockholder is interested only because he is an income tax payer.

The Government contends that the phrase "most recently accumulated undivided profits or surplus" in § 31 (b) includes current earnings of the year in which the dividends are paid; and that, as the earnings of 1917 were ample to pay these dividends, the 1917 dividends are conclusively presumed to have been paid out of 1917 earnings. The fiscal year of Phelps Dodge Corporation coincides with the calendar year. The corporation earned in 1917 a net profit of $16,742,487.06. The two distributions here involved amounted to only $3,600,000. The corporation paid from time to time during 1917, in all, ten dividends aggregating

[1]The estate had also contended that the word "deemed" merely "gave rise to a rebuttable presumption, subject to be rebutted by showing the fund out of which the corporation actually paid the dividend." This contention was denied by both lower courts and was not made in this Court.

$14,400,000. A large excess remained, to be added to the surplus account on closing the books as of December 31, 1917. There was no suggestion by the Douglas estate that when these dividends were paid, the current undistributed 1917 earnings of the corporation then accrued were in fact insufficient to pay the two dividends. The District Court found that, under a *pro rata* apportionment, they were "more than sufficient." It is not suggested that the approximate amount of the undivided current earnings of 1917 accrued and undivided at the times these dividends were paid was not in fact known to be sufficient for this purpose. Nor is it suggested by the Douglas estate that the exact facts, or the knowledge thereof by the corporation at the times when the dividends were declared or paid, are of legal significance.

The claim of the Douglas estate is that the current profits are not, within the meaning of the Act, the "most recently accumulated undivided profits or surplus," from which the distributions "shall be deemed to have been made;" and that what Congress intended was that a dividend should be deemed to have been paid from the most recent accumulation of profits which, before payment of the dividend, appeared on the books as having been added to the undivided profits or surplus account of a fiscal year. The argument is that the income tax is levied generally with reference to the period of a full year; that the net financial results of the full calendar and fiscal year of a corporation cannot be known until the expiration of the fiscal year; that the words used by Congress have in corporate accounting a well known technical meaning; that this meaning is earnings which have been determined by the taking of inventories and the balancing of books to constitute "undivided profits or surplus"; that it was after December 31, 1917, before the net financial results of the operations of that year were formally and definitely determined by this corporation by the usual taking of the annual inventory, the balancing of the books, and the carrying of the "undivided profits or surplus" to the appropriate account; that the most recently accumulated undivided profits so appearing was the undistributed balance of the profits earned in the year 1916, which was shown on the books as closed under date of December 31, 1916, and appeared in the surplus account; that this balance was sufficient in amount to meet these two dividends; and that it must be deemed to have been applied in paying them.

In short, the claim of the Douglas estate is that Congress in providing by § 31 (b) that dividends shall be deemed to have been paid "from the most recently accumulated undivided profits or surplus" meant from such balance as, at the time of the payment of the dividend, is shown by the undivided profits or surplus account of the preceding fiscal year.

The Douglas estate, apparently, does not contend that under the 1917 Act dividends are not to be taxed at all unless there was an existing balance of taxable profits in the surplus or undivided profits account from which they can be considered to have been paid. To have so contended would have been to impute to Congress the intention of exempting from taxation the dividends received in 1917 by those individuals who were stockholders in corporations which earned in 1917 large sums and paid them out in dividends during that year,[2] but which had no earned surplus at the close of their fiscal year on December 31, 1916, or whose earned surplus consisted wholly of profits earned prior to March 1, 1913. The Douglas estate grafts upon the section an implied condition or limitation. Its position seems to be that § 31 (b) applies if, and only if, at the time of the payment of the dividend, there was on hand an undistributed part of the taxable earnings of some prior fiscal year or years. In other words, it asserts that Congress, in providing that a distribution to shareholders should "be deemed to have been made from the most recently accumulated undivided profits or surplus," implied the condition—"if there are such accumulated profits or surplus not exempt from taxation"; that if there are available no such undivided profits or surplus,

[2]This, as a business matter, could easily be done, and is, in fact, done by many corporations. Nearly every business with a well developed accounting system can, at any time, without the formal periodic inventory or closing of its books usual at the end of a fiscal year, determine approximately the amount of its current earnings, the amount accrued since the beginning of its fiscal year, and the part thereof undistributed. Many corporations do make such approximate ascertainment of profits monthly, or oftener. And relying upon their system of cost-accounting, they make distributions of current earnings without a closing of the books, as the Phelps Dodge Corporation did in 1917.

This is shown by the record to be true of the Phelps Dodge Corporation. It paid during 1917 regular and extra dividends on June 28, on September 28, and on December 28, aggregating $8,100,000, which were declared, in its report to stockholders, to have been paid by it "out of earnings for the year 1917."

accrued subsequent to March 1, 1913, the distribution will be considered to have been made from current earnings; that such dividends, in that event, would be taxable as income under § 2 (a) of the Revenue Act of 1916, 39 Stat. 757, as amended by § 1200 of the 1917 Act, 40 Stat. 329; and that the 1917 rates would apply. Whether, at the time these 1917 dividends were paid, there was in the surplus account as of December 31, 1916, such funds sufficient for their payment, as the Court of Appeals appears to have found, we have no occasion to consider. For we are of the opinion that, in any event, the District Court was right in holding that these 1917 dividends must be deemed to have been paid out of the 1917 earnings, and that the stockholder was taxable thereon at the 1917 rate.

The legislative history of § 31(b) is relied upon by the Douglas estate in support of its construction. On the other hand, the Government relies upon the legislative history of the Revenue Act of 1918, Act of February 24, 1919, c. 18, 40 Stat. 1057, passed by the same Congress which enacted the Revenue Act of 1917. Enquiries into the detail of legislative history are sometimes helpful in removing a doubt presented by the language used in a statute. *Penn Mutual Life Ins. Co.* v. *Lederer*, 252 U. S. 523, 537. But we have no occasion here to resort to that aid in construing the phrase in question. To ascertain its meaning, we need only bear in mind the general character of the income tax, the specific practices of corporations concerning profits and dividends, the prior income-tax legislation to which § 31 (b) is an amendment, and the time of the latter's enactment.

Ordinarily, an income tax is laid upon all taxable income actually received during the tax-year and the tax is payable at the tax-rate of the year in which it is received, although none of the income may have been earned by the taxpayer during that year, or, where the income consists of dividends, although the corporation may not have earned in that year any part of the profits of which the dividend is a distribution. The Act of October 3, 1913, c. 16, § II, 38 Stat. 114, 166, the first income-tax law enacted after the adoption of the Sixteenth Amendment, was construed by the Treasury Department as embodying this general rule without any exception. Consequently, the Treasury exacted such payment on account of all income received by the taxpayer after March 1,

1913, the effective date of the Amendment, although it appeared that all of the income had been earned before that date either by the taxpayer or by the corporation whose profits were distributed as a dividend. The correctness of the Treasury's construction was questioned; and before the second income tax law was enacted, September 8, 1916, c. 463, Title I, 39 Stat. 756, lower federal courts had in, *Lynch* v. *Hornby*, 236 Fed. 661, held the Treasury construction to be erroneous. There had also been serious contention that, as construed by the Treasury, the provision was, when applied to dividends, both unconstitutional and unjust.[3] These contentions apparently prevailed with Congress when in framing the 1916 Act, it raised the normal tax-rate from 1 per cent. to 2 per cent. and the maximum additional tax (super-tax) from 6 per cent. to 13 per cent. The 1916 Act, by a proviso to § 2, limited the tax on dividends to distributions "made or ordered to be made by a corporation . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen . . ." Soon after came the War; the great need of the Government for large revenues; and the large war-profits. Congress enacted the 1917 War Income Tax law, which raised the normal tax rate to 4 per cent. and the maximum additional tax to 63 per cent.; and it made the provision retroactive, in the main, to January 1 of that year.

While the 1917 Act was under consideration, it was recognized that this rapid increase in the income tax rate might result in unjust discrimination if no change were made in the then existing rule governing the taxation of dividends. All profits earned by members of a partnership would be taxed at the rate prevailing in the year in which they were earned, although actually withdrawn in a later year when the tax rate was much higher. On the other hand, the tax upon the profits of a corporation earned in 1916 or earlier, would, if paid out in 1917 as dividends, be taxed at the high 1917 rates. There would be similar discrimination among the holders of stock in different corporations. The stockholders in those corporations which had deferred the distribution of profits earned prior to 1917, either generally from prudence or specifically with a view to stabilizing over a long period the rate of dividend,

[3]The decision in this Court of Lynch v. Hornby, 247 U. S. 339, which sustained the Treasury's construction and held the Act constitutional, was not rendered until June 3, 1918. See also Peabody v. Eisner, 247 U. S. 347.

would be at a great disadvantage as compared with the stockholders in those corporations which had pursued the practice of distributing each year substantially all profits earned. On the other hand, if corporations were left free to determine out of what year's profits dividends paid in 1917 and subsequent years should be deemed to have been made, a corporation with a surplus derived from earnings made prior to 1917 could, while accumulating the profits of the war years, pay dividends on which its stockholders would escape the heavy war tax, by simply declaring that the dividends were payable out of the earnings of earlier years. And if there were still on hand such sufficient surplus earnings from the period prior to March 1, 1913, the dividends would be exempt from all tax. It was apparently to obviate such inequalities that Congress provided by § 31 (b) for an objective consideration of the date when the corporation earned the profits, as well as the date when the taxpayer received his share of them in the form of the dividend. By implying the condition stated above the Douglas estate escapes from a position which would otherwise impute to Congress the intention of enabling the war profits of 1917 and subsequent years actually distributed as dividends to escape from the war taxes. But in implying the condition it imputes to Congress, which was seeking to prevent discrimination against stockholders in those corporations which had on January 1, 1917, surplus profits earned since March 1, 1913, the intention of grossly discriminating in their favor. For if this condition is read into the Act, stockholders in corporations which had no such surplus on December 31, 1917, are taxable on 1917 dividends at the high 1917 rates; while those in corporations which had such surplus are taxable on 1917 dividends at the lower rates of 1916 or earlier years.

Congress did not use the words "surplus account" or "undivided profits account." Its language is "undivided profits or surplus". The word "surplus" is a term commonly employed in corporate finance and accounting to designate an account on corporate books. But this is not true of the words "undivided profits." The surplus account represents the net assets of a corporation in excess of all liabilities including its capital stock. This surplus may be "paid-in surplus," as where the stock is issued at a price above par. It may be "earned surplus", as where it was derived wholly from undistributed profits. Or it may, among

other things, represent the increase in valuation of land or other assets made upon a revaluation of the company's fixed property. See *La Belle Iron Works* v. *United States*, 256 U. S. 377, 385. As used in § 31 (b) the term undoubtedly means that part of the surplus which was derived from profits which, at the close of earlier annual accounting periods, were carried into the surplus account as undistributed profits. On the other hand, the term "undivided profits" has not acquired in corporate finance and accounting a like fixed meaning. It is not known as designating generally in business an account on the corporation's books, as distinguished from profits actually earned but not yet distributed.[4] Few business corporations establish an "undivided profits" account.[5] By most corporations the term "undivided profits" is employed to describe profits which have neither been distributed as dividends nor carried to surplus account upon the closing of the books; that is, current undistributed earnings.

That this is the natural meaning of the term "undivided profits" is indicated by the action of both Douglas and his estate.[6] That

[4]The Committee on Accounting Terminology of the American Association of Public Accountants was for years engaged in preparing a list of definitions. That contained in the Year Book of 1913, pp. 176-227, gives at p. 226 this definition: "Undivided Profits—Earnings or profits which have not been divided among the partners in a firm or the stockholders in a corporation."

[5]The Interstate Commerce Commission prescribes for the various classes of corporations subject to its supervision about 13 different forms of accounts, all of which include a general balance sheet. The number of items on the liability side of this balance sheet varies in these several forms from 8 to 33. There is no item "undivided profits" in any form.

By incorporated banks the term is commonly employed to designate the account in which profits are carried more or less temporarily, in contradistinction to the account called surplus in which are carried amounts treated as permanent capital, and which may have been derived from payments for stock in excess of par, or from profits which have been definitely devoted to use as capital. See Fidelity Title & Trust Co. v. United States, 259 U. S. 304, 308.

[6]Douglas received (see note 2, *supra*) from Phelps Dodge Corporation during 1917 six other dividends, aggregating $738,900, which were confessedly paid out of the 1917 profits—and which were reported by him as taxable in his return to the Commissioner of Internal Revenue. The two dividends here in question were reported by him in his return as not taxable solely on the ground that they were "depletion dividends." It was on this ground only that the estate, in its applications to the Treasury, sought recovery of the amount in suit.

this is the meaning in which it was used by Congress is confirmed by the use of the expression "earnings and profits" later in the same paragraph;[7] and, also, by the use of the term "undivided profits" in § 207.[8] If it be accepted as the meaning in which Congress used the words, the course to be pursued under § 31 (b) becomes consistent with the general purpose evidenced by other parts of the Act. Its general aim was clearly to make the dividend, in whatever year paid, bear the tax rate of the year in which the profits of which it was a distribution had been earned; and for this purpose to treat as a unit the profits of the whole tax year. In providing measures for the attainment of that aim, it could be of no practical significance whether, at the time of the payment of the dividend, these profits appeared in a surplus or undivided profits account (as the profits earned within part of a year would where a corporation closed its books monthly, quarterly, or semi-annually) or whether they still rested as current earnings without formal determination or specific allocation.

Besides this general aim, Congress had the special aim of making the war profits pay the high war taxes.[9] To this end it was essential that the law should, in determining the applicable tax rate,

[7] § 31 (b) " . . but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen."

[8] In § 207 of the same Act, which deals with the War Excess Profits Tax on corporations and makes the tax dependent on the amount of the invested capital, the term "undivided profits" is likewise used. That section, in paragraph (a) 3 defines invested capital as including "paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year."

[9] To discourage the hoarding of profits in order to avoid the tax, two supplemental provisions were incorporated in the Act. By § 3, incorporating § 3 of the Revenue Act of 1916, Congress taxed as income received by the stockholder his proportion of profits earned by the corporation and fraudulently hoarded by it to avoid payment of the tax. By § 1206(2), adding § 10 (b) to the Revenue Act of 1916, it subjected the corporation to an additional tax of 10 per cent. on undistributed income not employed in the business, unless invested in obligations of the United States.

disregard any declaration of the corporation as to what year's profits were being distributed. Not only was it essential that every such declaration of the corporation should be disregarded, but also that the dividend should not thereupon be deemed to have been paid from the profits of the earliest year (since March 1, 1913) of which there remained accumulated profits available for distribution. To accomplish the purpose of Congress it was necessary that the dividend be deemed to have been paid out of the available profits or earnings of the most recent year or years. Its intention so to provide was adequately expressed by the use of the phrase "most recently accumulated" in connection with the words "undivided profits or surplus." As, in the case at bar, there were profits of the year 1917 ample to cover all dividends, those here in suit must be deemed to have been paid therefrom.

Reversed.

Mr. Justice VAN DEVANTER, Mr. Justice MCREYNOLDS, Mr. Justice SUTHERLAND, and Mr. Justice BUTLER, dissent.

A true copy.

Test:

Clerk, Supreme Court, U. S.